APPENDIX

In the Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-305

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

FIRST SECURITY BANK OF UTAH, N.A., *et al.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI FILED JUNE 18, 1971

CERTIORARI GRANTED OCTOBER 12, 1971

In the Supreme Court of the United States

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COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

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FIRST SECURITY BANK OF UTAH, N.A., *et al*,

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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TAX COURT OF THE UNITED STATES

DOCKET No. 1190-63

FIRST SECURITY BANK OF UTAH, N.A., *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

RELEVANT DOCKET ENTRIES

Date	Filings and Proceedings
Mar. 20, 1963	PETITION FILED: FEE PAID; Served March 20, 1963
May 2, 1963	ANSWER FILED by Respondent; Served May 6, 1963
Feb. 8, 9, 1967	TRIAL at San Francisco, California by Judge Fay
Feb. 8, 9, 1967	Petr. oral motion to compel election by resp. between alternative remedies—DENIED. Petrs. motion to exclude issue or, in the alternative, to shift burden of proof—Filed, Denied and Served Feb. 9, 1967. (In 1190-63 & 1216-63 Only). Petr. motion to exclude issue or, in the alternative to shift burden of proof—Filed, Denied and Served Feb. 9, 1967. (In 1190-63, 1191-63 & 1216-63).
	STIPULATION Filed. STIPULATION OF FACTS Filed. SECOND SUPPLEMENTAL STIPULATION OF FACTS filed.
Mar. 3, 1967	ORDER, that (Dkts. 1190-63, 1191-63 & 1216-63) are hereby consolidated for purposes of trial, briefs and opinion.
Dec. 27, 1967	MEMORANDUM FINDINGS OF FACT AND OPINION filed Judge Fay.

Date	Filings and Proceedings
Jan. 26, 1968	MOTION by petr. to alter and amend findings and for reconsideration. DENIED March 19, 1968.
May 7, 1969	DECISION entered, Judge Fay. Served May 7, 1969
July 28, 1969	NOTICE of appeal to U.S.C.A., 10th Cir., filed by Petrs. Served July 29, 1969

TAX COURT OF THE UNITED STATES

DOCKET No. 1216-63

FIRST SECURITY BANK OF IDAHO, N.A., *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

RELEVANT DOCKET ENTRIES

Date	Filings and Proceedings
Mar. 21, 1963	PETITION FILED: FEE PAID Mar. 21, 1963; Served Mar. 21, 1963
May 2, 1963	ANSWER filed by Resp. Served May 6, 1963
Feb. 8, 9, 1967	TRIAL at San Francisco, California by Judge Fay.
Feb. 8, 9, 1967	Petr. oral motion to compel election by resp. between alternative remedies—DENIED. Petrs. motion to exclude issue or, in the alternative, to shift the burden of proof—Filed, Denied and Served Feb. 9, 1967. (In 1190-63 & 1216-63 only). Petr. motion to exclude issue or, in the alternative to shift the burden of proof—Filed, Denied and Served Feb. 9, 1967. (In 1190-63, 1191-63 & 1216-63).

Date	Filings and Proceedings
	STIPULATION FILED. STIPULATION OF FACTS filed. SECOND SUPPLEMENTAL STIPULATION OF FACTS filed.
March 3, 1967	ORDER, that (Dkts. 1190-63, 1191-63 & 1216-63) are hereby consolidated for purposes of trial, briefs and opinion.
Dec. 27, 1967	MEMORANDUM FINDINGS OF FACT AND OPINION filed Judge Fay.
Jan. 26, 1968	MOTION by petr. to alter and amend findings and for reconsideration. DENIED March 19, 1968.
May 7, 1968	DECISION entered, Judge Fay. Served May 7, 1969.
July 31, 1969	NOTICE OF Appeal to U.S.C.A., 10th Cir. filed by Petr. Served Aug. 1, 1969.
Aug. 6, 1969	NOTICE of Appeal to U.S.C.A., 9th Cir. filed by Petr. Served Aug. 7, 1969.
Oct. 8, 1969	STIPULATION OF VENUE to U.S.C.A., 10th Cir. filed.

United States Court of Appeals
For the Tenth Circuit

Docket Nos. 611/69 and 612/69

[*Caption Omitted*]

Relevant Docket Entries

Date	Filings—Proceedings
11/3/69	Cause docketed; leave granted to docket out of time—WLW
11/4/69	Assigned to General Calendar
12/15/69	Appellant's brief
3/3/70	Brief of Appellee
4/14/70	Appellant's Reply brief
9/21/70	Argued and submitted—Breitenstein, Seth, Templar
1/21/71	Opinion, *Breitenstein;* Seth; Templar, Dist. Judge; Judgment: Reversed.
2/12/71	Mandate and original record on appeal to Clerk

IN THE TAX COURT OF THE UNITED STATES

[*Caption Omitted*]

PETITION

Docket No. 1190-63

(Filed March 20, 1963)

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Form L-21A Ap:SLC:WBH-90D:BLG) dated December 21, 1962, and as a basis for its petition alleges as follows:

1. Petitioner is a national bank, with its principal office at 79 South Main Street, Salt Lake City, Utah. The federal income tax returns for the taxable years here involved were filed with the District Director for the Utah District at Salt Lake City, Utah.

2. The notice of deficiency, a copy of which is attached hereto and marked Exhibit A, was mailed to the petitioner on December 21, 1962.

3. The deficiencies, as determined by the Commissioner, are in income taxes for the taxable years ending December 31, 1954, to and including December 31, 1959, in the total aggregate amount of $497,953.34, all of which said amount is in dispute. The following table shows the amount of the deficiency determined for each of the taxable years:

Year	Deficiency
1954	$ 68,250.00
1955	28,775.81
1956	54,526.56
1957	77,862.91
1958	159,371.46
1959	109,166.60
	$497,953.34

4. The determination of deficiencies in tax set forth in the said notice of deficiency is based upon the following errors:

* * * * *

(b) The Commissioner erred in determining for the

taxable years 1955, 1956, 1957, 1958 and 1959 that the insurance premiums and/or commission income reported as income by the First Security Life Insurance Company of Texas, a corporation, or any part of it, should have been reported by petitioner and that therefore petitioner's taxable income and its tax liability for each of the taxable years 1955 to and including 1959 should be increased as set forth in the following table:

Year	Taxable Income	Tax Liability
1955	$ 55,338.08	$ 28,775.81
1956	104,858.79	54,526.56
1957	149,736.36	77,862.91
1958	306,483.59	159,371.46
1959	209,935.77	109,166.60

5. The facts upon which petitioner relies as a basis of this case are as follows:

* * * *

(b) The said deficiency notice completely fails to set forth any of the factual or legal grounds upon which the Commissioner has based his determination that petitioner should report as its own the indicated income of First Security Life Insurance Company of Texas for the taxable years 1955 through 1959. The Commissioner's determination is therefore arbitrary and capricious. Moreover, it is impossible for petitioner, without indulging in speculation, to make responsive factual allegations except to state that petitioner is not, was not and cannot be in the insurance business, and does not and did not have any contract or agreement or understanding with any insurance company which entitled it in the taxable years involved to receive any insurance premiums and/or commission income that was paid to the First Security Life Insurance Company of Texas.

Wherefore, petitioner prays that this Court determine that there is no deficiency in income tax for any of the taxable years 1954, 1955, 1956, 1957, 1958 and 1959.

Respectfully submitted,

C. Preston Allen

Alonzo W. Watson, Jr.
Attorneys for Petitioner
c/o Ray, Quinney & Nebeker

Verified

Exhibit A

U.S. Treasury Department, Internal Revenue Service, Office Of Regional Commissioner.

Appellate Division 400 Tribune Building, Salt Lake City 11, Utah.

In Reply Refer to Form L-21A Ap:SLC:WBH-90D:BLG
Certified Mail Dec 21 1962

First Security Bank of Utah, N. A. c/o Mr. C. Preston Allen, c/o Ray, Quinney & Nebeker, 300 Deseret Building, Salt Lake City 11, Utah.

Gentlemen:	Taxable Year Ended	Deficiency
	12-31-54	$ 68,250.00
	12-31-55	28,775.81
	12-31-56	54,526.56
	12-31-57	77,862.91
	12-31-58	159,371.46
	12-31-59	109,166.60
		$497,953.34

In accordance with the provisions of existing internal revenue laws, notice is given that the determination of your income tax liability for the above-noted taxable year(s) discloses a deficiency (or deficiencies) in the amount(s) shown above. The attached statement shows the computation of the deficiency or deficiencies.

If You Agree to this determination, please sign the enclosed agreement, Form 870, and return it promptly to this office. An addressed envelope is enclosed for this purpose. The signing and filing of this agreement will permit an early assessment of the deficiency or deficiencies and will limit the accumulation of interest.

If You Do Not Agree, and do not sign and return the enclosed form, the deficiency or deficiencies will be assessed for collection, as required by law, upon the expiration of ninety days from the date of this letter, unless within that time you contest this determination in the Tax Court of the United States by filing a petition with that Court in accordance with its rules, a copy of which may be obtained by writing to its Clerk, Box 70, Washington 4, D.C.

Very truly yours,
MORTIMER M. CAPLIN
Commissioner
By DENVER E. WATSON
Associate Chief, Appellate Division

Enclosures: Statement; Agreement, Form 870; Addressed envelope.

Statement

Ap: SLC:WBH
90-D:BLG

First Security Bank of Utah, N. A., c/o Mr. C. Preston Allen, Ray, Quinney & Nebeker, 300 Deseret Building, Salt Lake City 11, Utah.

Tax Liability for the Taxable Years Ended December 31, 1954 to December 31, 1959, Inclusive.

Year		Deficiency
1954	Income Tax	$ 68,250.00
1955	Income Tax	28,775.81
1956	Income Tax	54,526.56
1957	Income Tax	77,862.91
1958	Income Tax	159,371.46
1959	Income Tax	109,166.60
		$497,953.34

In making this determination of your income tax liability, careful consideration has been given to your protests dated October 1, 1959, and June 12, 1961, and to the statements made at the conferences held on September 26, 1962, and prior dates.

A copy of this letter and statement has been mailed to your representatives, S. J. Quinney, Paul H. Ray, C. Preston Allen, Lynn E. Baxter, Gordon L. Barney, and Alonzo W. Watson, Jr., c/o Ray, Quinney & Nebeker, 300 Deseret Building, Salt Lake City 11, Utah, in accordance with the authority contained in the power of attorney executed by you.

* * * *

IN THE TAX COURT OF THE UNITED STATES

[*Caption Omitted*]

PETITION

Docket No. 1216-63

(Filed March 21, 1963)

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Form L-21A Ap:SLC:WBH-90D:BLG) dated December 21, 1962, and as a basis for its petition alleges as follows:

1. Petitioner is a national bank, with its principal office at 905 Idaho Street, Boise, Idaho. The federal income tax returns for the taxable years here involved were filed with the District Director for the Idaho District at Boise, Idaho.

2. The notice of deficiency, a copy of which is attached hereto and marked Exhibit A, was mailed to the petitioner on December 21, 1962.

3. The deficiencies as determined by the Commissioner are in income taxes for the taxable years ending December 31, 1954, 1955, 1957 and 1958, in the total aggregate amount of $357,535.08, all of which said amount is in dispute. In addition, the Commissioner on page 2 of the Statement attached to his said notice of deficiency has determined as an adjustment to income for the taxable year 1959 that petitioner had insurance premium receipts of $135,353.32, and reduced the operating loss of $1,143,485.81 reported by petitioner on its income tax return for 1959 by said amount of $135,353.32. Petitioner contends that the said adjustment to income for the taxable year 1959 is also erroneous and that its operating loss for said year should be increased by the said $135,353.32. Furthermore, on said page 2 of said deficiency notice, the Commissioner determined as an adjustment to income for the taxable year 1956 that petitioner had insurance premium receipts of $79,751.75, which increased the amount of taxable income against which part of petitioner's net operating loss deduction for 1959 was applied. Petitioner contends that the said adjustment for the said taxable year 1956 is also erroneous and that there-

fore it should have a larger net operating loss to apply against its tax liability for the year 1957. The following table shows the amount of the deficiency determined for each of the taxable years:

Year	Deficiency
1954	$ 68,250.00
1955	26,139.85
1957	160,392.56
1958	102,752.08
	$357,535.08

4. The determination of deficiencies in tax set forth in the said notice of deficiency is based upon the following errors:

* * * * *

(b) The Commissioner erred in determining that for the taxable years 1955, 1956, 1957, 1958 and 1959 that the insurance premiums and/or commission income reported as income by First Security Life Insurance Company of Texas, or any part of it, should have been reported by petitioner, and that therefore petitioner's taxable income for each of the taxable years 1955 to and including 1959 should be increased as set forth in the following table:

Year	Taxable Income
1955	$ 50,268.95
1956	79,751.75
1957	93,342.14
1958	197,601.26
1959	135,353.32

5. The facts upon which petitioner relies as a basis of this case are as follows:

* * * *

(b) The said deficiency notice completely fails to set forth any of the factual or legal grounds upon which the Commissioner has based his determination that petitioner should report as its own the indicated income of First Security Life Insurance Company of Texas for the taxable years 1955 through 1959. The Commissioner's determination is therefore arbitrary and capricious. Moreover, it is impossible for petitioner, without indulging in speculation,

to make responsive factual allegations except to state that petitioner is not, was not and cannot be in the insurance business, and does not and did not have any contract or agreement or understanding with any insurance company which entitled it in the taxable years involved to receive any insurance premiums and/or commission income that was paid to the First Security Life Insurance Company of Texas.

Wherefore, petitioner prays that this Court determine

1. That there is no deficiency in income tax for any of the taxable years 1954, 1955, 1957 and 1958; and

2. That petitioner's operating loss for 1959 be increased in the amount of $135,353.32 and its net operating loss available for the taxable year 1957 be increased in the amount of $215,105.07.

Verified

Respectfully submitted

C. Preston Allen

Alonzo W. Watson, Jr.
Attorneys for Petitioner
c/o Ray, Quinney & Nebeker

Exhibit A

U.S. Treasury Department, Internal Revenue Service, Office Of Regional Commissioner.

Appellate Division 400 Tribune Building, Salt Lake City 11, Utah.

In Reply Refer to Form L-21A Ap:SLC:WBH-90D:BLG
Certified Mail Dec 21 1962

First Security Bank of Idaho, N. A., c/o Mr. C. Preston Allen, Ray, Quinney & Nebeker, 300 Deseret Building, Salt Lake City, Utah.

Gentlemen:

Taxable Year Ended	Deficiency
12-31-54	$ 68,250.00
12-31-55	26,139.85
12-31-57	160,392.56
12-31-58	102,752.67
	$357,535.08

In accordance with the provisions of existing internal revenue laws, notice is given that the determination of your

income tax liability for the above-noted taxable year(s) discloses a deficiency (or deficiencies) in the amount(s) shown above. The attached statement shows the computation of the deficiency or deficiencies.

If You Agree to this determination, please sign the enclosed agreement, Form 870, and return it promptly to this office. An addressed envelope is enclosed for this purpose. The signing and filing of this agreement will permit an early assessment of the deficiency or deficiencies and will limit the accumulation of interest.

If You Do Not Agree, and do not sign and return the enclosed form, the deficiency or deficiencies will be assessed for collection, as required by law, upon the expiration of ninety days from the date of this letter, unless within that time you contest this determination in the Tax Court of the United States by filing a petition with that Court in accordance with its rules, a copy of which may be obtained by writing to its Clerk, Box 70, Washington 4, D.C.

Very truly yours,

MORTIMER M. CAPLIN
Commissioner

By DENVER E. WATSON
Associate Chief, Appellate Division

Enclosures: Statement; Agreement, Form 870; Addressed envelope.

Statement

Ap:SLC:WBH
90-D:BLG

First Security Bank of Idaho, N. A., c/o Mr. C. Preston Allen, Ray, Quinney & Nebeker, 300 Deseret Building, Salt Lake City 11, Utah.

Tax Liability for the Taxable Years Ended December 31, 1954, December 31, 1955, December 31, 1957, and December 31, 1958.

Year		Deficiency
1954	Income Tax	$ 68,250.00
1955	Income Tax	26,139.85
1957	Income Tax	160,392.56
1958	Income Tax	102,752.67
Total		$357,535.08

In making this determination of your income tax liability, careful consideration has been given to your protest dated June 8, 1961; to the statements made at the conferences held on August 11, 1961, February 16, 1962, March 22, 1962, August 14, 1962, August 28, 1962, and September 26, 1962; and to your claim for refund, Form 1139, filed on March 8, 1960.

A copy of this letter and statement has been mailed to your representatives, S. J. Quinney, Paul H. Ray, C. Preston Allen, Lynn E. Baxter, Gordon L. Barney, and Alonzo W. Watson, Jr., c/o Ray, Quinney & Nebeker, 300 Deseret Building, Salt Lake City, Utah, in accordance with the authority contained in the power of attorney executed by you.

* * * *

TAX COURT OF THE UNITED STATES

[*Caption Omitted*]

ANSWER

Docket No. 1190-63

(Filed May 2, 1963)

The Respondent, in answer to the petition filed in the above-entitled case, admits and denies as follows:

1, 2, and 3. Admits the allegations of paragraphs 1, 2, and 3 of the petition.

4 (a) and (b). Denies the allegations of error in subparagraphs 4 (a) and (b) of the petition.

5 (a) and (b). Denies the allegations in subparagraphs 5 (a) and (b) of the petition.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the deficiency determined by the respondent be in all respects approved.

Of Counsel:
MELVIN L. SEARS
Regional Counsel
JAMES BOOHER
Attorney
Internal Revenue Service

CRANE C. HAUSER
Chief Counsel
Internal Revenue Service

Served May 6 1963

TAX COURT OF THE UNITED STATES

[*Caption Omitted*]

ANSWER.

Docket No. 1216-63

(Filed May 2, 1963)

The Respondent, in answer to the petition filed in the above-entitled case, admits and denies as follows:

1 and 2. Admits the allegations of paragraphs 1 and 2 of the petition.

3. Admits that the deficiencies as determined by the Commissioner are in income taxes for the taxable years ending December 31, 1954, 1955, 1957 and 1958, in the total aggregate amount of $357,535.08, all of which said amount is in dispute; that the Commissioner made adjustments to petitioner's reported income as set forth in the statutory notice of deficiency and that the following table shows the amount of the deficiency determined for each of the taxable years:

Year	Deficiency
1954	$ 68,250.00
1955	26,139.85
1957	160,392.56
1958	102,752.08
	$357,535.08

Denies the remaining allegations of paragraph 3 of the petition.

4 (a) and (b). Denies the allegations of error in subparagraphs 4 (a) and (b) of the petition.

5 (a) and (b). Denies the allegations in subparagraphs 5 (a) and (b) of the petition.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the deficiency determined by the respondent be in all respects approved.

CRANE C. HAUSER
Chief Counsel
Internal Revenue Service

Of Counsel: Melvin L. Sears, Regional Counsel; James Booher, Attorney, Internal Revenue Service.

STIPULATION OF FACTS

[*Caption Omitted*]

It is hereby stipulated that, for the purposes of these cases, the following statements may be accepted as facts and all exhibits referred to herein and attached hereto are incorporated in this stipulation and made a part hereof; provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated, and that either party may object to the relevancy or materiality of these statements or exhibits.

1. On December 21, 1962, respondent mailed a notice of deficiency to each of the petitioners. Correct copies of the deficiency notices mailed to each of the petitioners are attached hereto as Exhibit CC-48 and made a part hereof.

2. The petitions filed by the respective petitioners herein were timely filed according to law, and these consolidated actions are in all respects properly before the Court.

3. Petitioners filed income tax returns with the District Director of Internal Revenue Service, at Salt Lake City, Utah, or Boise, Idaho, as follows:

Petitioner	Years for Which Returns Filed	Filed with District Director of Internal Revenue at
First Security Bank of Utah, N. A.	1954-1959	Salt Lake City
First Security Bank of Idaho, N. A.	1954-1958	Boise
First Security Company	1956-1959	Salt Lake City

Each petitioner's principal place of business, when its petition was filed, was as follows:

Petitioner	Principal Place of Business
First Security Bank of Utah, N. A.	Salt Lake City, Utah
First Security Company	Salt Lake City, Utah
First Security Bank of Idaho, N. A.	Boise, Idaho

4. From 1954 through October, 1959, petitioners were wholly-owned subsidiaries of the First Security Corporation, a publicly-owned bank holding company. During these years, First Security Corporation had approximately 1,044,963 shares of common voting stock outstanding and from 2,000 to 3,000 shareholders residing in various states and foreign countries.

5. Petitioner First Security Bank of Utah, N. A., is a national bank incorporated in 1882. It is subject to supervision, inspection and control by the Board of Governors, Federal Reserve System, the Federal Deposit Insurance Corporation, and the Comptroller of Currency, and is regularly examined by these agencies. During the years in issue, this bank had numerous branches, approximately 141,000 to 192,000 depositors, and approximately $217,000,000 to $292,000,000 in deposits.

6. Petitioner First Security Bank of Idaho is a national bank, incorporated as such in 1941, after operating since 1865 as a state bank. It is subject to supervision, inspection and control by the Board of Governors, Federal Reserve System, the Federal Deposit Insurance Corporation, and the Comptroller of Currency, and is regularly examined by these agencies. During the years in issue, this bank had numerous branches, approximately 113,000 to 131,000 depositors, and approximately $183,000,000 to $205,000,000 in deposits.

7. Petitioner First Security Company is a management company organized under the laws of the state of Utah in 1929. This corporation is subject to control, supervision and inspection by the Board of Governors of the Federal Reserve System and regularly inspected by this agency. This company provides management and related services (e.g., accounting, auditing and supervisory assistance) to related banking subsidiaries of the First Security Corporation.

8. From 1954 through October, 1959, First Security Corporation's wholly-owned subsidiaries, in addition to petitioners, included:

(a) The first Security Life Insurance Company of Texas (hereinafter called Security Life), a corporation organized and licensed as an insurance company pursuant to the laws of Texas on or about June 15, 1954. At incorporation, Security Life had a paid-in capital of 2,500 shares of $10

par value common stock and a paid-in surplus of $12,500. Its capital was increased in 1956 to $100,000.

(b) Ed D. Smith & Sons (hereinafter called Smith), a Utah corporation. First Security Corporation acquired Smith in 1948. During the years in issue Smith had approximately twenty employees, sold life and casualty insurance, and reported for federal income tax purposes a gross income of between $152,000 and $303,000. Its yearly premium volume was approximately $800,000.

(c) First Security Insurance Agency, Inc. (hereinafter called Agency, Inc.), an Idaho corporation. First Security Corporation acquired Agency, Inc. on or about August 10, 1946. During the years in issue, this corporation sold insurance and had yearly premium volume of approximately $175,000.

(d) First Security State Bank, a Utah state bank, with approximately 9,500 to 11,000 depositors and $9,000,000 in deposits. First Security Corporation acquired this bank on or about October 21, 1957. This bank is subject to supervision, inspection, and control by the Utah State Banking Department and Federal Deposit Insurance Corporation and is regularly examined by these agencies.

(e) First Security Bank, Rock Springs, Wyoming, a Wyoming state bank with deposits of approximately $3,-000,000 to $5,000,000 and approximately 2,000 depositors. First Security Corporation acquired this bank in 1928. This bank is subject to supervision, inspection and control by the Wyoming State Board of Banking Examiners and Federal Deposit Insurance Corporation, and is regularly examined by these agencies.

(f) Western Investment Corporation, an Idaho corporation holding various assets. The First Security Corporation acquired this company in 1931.

(g) Security Savings and Loan Association, a Utah state savings and loan association, with approximately $30,000,000 to $46,000,000 in deposits. The First Security Corporation organized this savings and loan association in 1954. This association is supervised by the Utah State Banking Department and regularly examined by this agency.

(h) First Security Savings and Loan Association, an Idaho state savings and loan association, with approximately $2,000,000 to $10,500,000 in deposits. This associa-

tion is supervised and controlled by the Home Loan Bank Board and the Idaho State Commission of Finance, and regularly examined by these agencies.

9. From 1948 through 1952, First Security Banks had available for their customers group credit, life, health, and accident insurance written by the Credit Life Insurance Company of Springfield, Ohio. Smith was designated as agent for Credit Life pursuant to an agency agreement between Smith and Credit Life, and commissions were paid by Credit Life during this time.

10. From January 1, 1953, through April 1, 1954, First Security Banks had available for those borrowing from them group credit life and group health and accident insurance written by the American Bankers Life Insurance Company of Florida. Smith was designated as agent for Bankers Life pursuant to an agency agreement between Smith and Bankers Life.

11. Before 1953, Credit Life paid commissions pursuant to its agency agreement with Smith. During 1953 and early 1954, the net premium, after deducting the commission, was remitted each month to Bankers Life.

12. Petitioner First Security Company reported the commissions and expense reimbursement payable to Smith from Credit Life and Bankers Life as income on its federal income tax returns.

13. From January 1, 1955, to December 31, 1959, Smith and Agency, Inc. were designated as agents for ANICO with respect to excess line insurance (i.e., insurance purchased by bank customers in excess of the coverage authorized by the group policies identified below).

14. Prior to and during the years in suit, the First Security Company, which provided a uniform system of accounting and performed similar services for the First Security Banks and other subsidiaries of the First Security Corporation, collected and transmitted life insurance premiums and reports to ANICO and other insurance companies.

* * * * *

23. Attached hereto are copies of the following documents:

Exhibits:

A-1 Income tax returns filed by First Security Bank of Utah for the years 1954 through 1959;

B-2 Income tax returns filed by the First Security Bank of Idaho for the years 1954 through 1959;

C-3 Income tax returns filed by the First Security Company for the years 195 [5] through 1959;

D-4 Credit Life Insurance Company policy No. 51710;

E-5 Credit Life Insurance Company policy No. 51961;

F-6 Agency agreement 1472;

G-7 Agency agreement 1472-A;

H-8 Specimen of Credit Life Insurance Co. application for credit life insurance;

I-9 Bankers Life group life insurance application dated 1-6-53;

J-10 American Bankers Life Assurance group life policy No. 1002;

K-11 Agency agreement between Smith and American Bankers Life dated 8-30-52;

M-13 Bankers Life Insurance Agency Agreement (with Kirk Landon) dated April 6, 1950;

N-14 American National group life policy No. 3405, and riders;

O-15 American National group life policy No. 4-3406, and riders;

P-16 Reinsurance Treaty effective April 1, 1954, with Amendments effective April 1, 1956 and August 1, 1955;

Q-17 Reinsurance Treaty No. 1 with Amendments effective Sept. 18, 1959, and January 1, 1960;

R-18 Reinsurance Treaty No. 2, effective Dec. 1, 1958, with Amendments effective Sept. 18, 1959 and Jan. 1, 1960;

S-19 American National group policy No. 8-5038;

T-20 Reinsurance Treaty effective Feb. 1, 1955, together with Amendments #1 and #2; and reinsurance treaty executed on April 22, 1957, and amendments dated Sept. 18, 1959;

U-21 American National group policy No. 1-3405, together with riders effective April 15, 1958, and January 1, 1956;

V-22 American National group policy No. 1-3406, together with riders;

W-23 Reinsurance Treaty effective January 1, 1956;

X-24 American National Insurance Co. group life policies No. 1-1956-003-004; and No. 1-1956-003-003;

Y-25 Reinsurance Treaty effective March 20, 1959, with Amendment effective Sept. 1, 1959;

Z-26 Agent's Agreements dated January 1, 1955 between American National and Agency, Inc.;

AA-27 Agent's Agreement dated January 1, 1955, between American National and Smith;

AC-28 Sample of insurance certificate issued by American National on policy No. 1-1956-003;

AD-29 Sample of American National Insurance certificate issued with respect to Insured Savings Account;

AE-30 Sample of American National Ins. Co. Excess Coverage certificate;

AF-31 Sample of American National Insurance Co. Life & Disability certificate (Idaho);

AG-32 Sample of American National Ins. Co. Life & Disability certificate (Utah);

AH-33 Sample of American National Ins. Co. Excess Coverage-Life & Disability;

AW-36 Minutes of the Regular Meeting Board of Directors, First Security Corp., 7/28/48;

BE-37 First page of Minutes of Meeting of Executive Committee First Security Corp., 4/1/54;

BG-39 Minutes of Meeting of Executive Committee, First Security Corp., June 8, 1956;

BO-40 Annual statements, or portions thereof, of First Security Life Insurance Co. of Texas;

BR-41 Income tax returns filed with the District Director, Internal Revenue Service, Dallas, Texas, by First Security Life Ins. Co. of Texas;

BS-42 A schedule showing the officers and directors of First Security Corporation and subsidiary corporations during the years 1954 through 1959;

BT-43 Articles of incorporation of Security Life, Smith and Agency, Inc.

44 Schedule setting forth the percentage of petitioner bank customers purchasing credit insurance during the years in issue;

BV-45 Schedule showing amount of commissions paid on sales of credit insurance by petitioner banks before 1954, and reported as income by the First Security Company;

BW-46 Copies of custodial arrangements between Security Life and petitioner banks;

BX-47 Copy of Security Life's 1957 state of California franchise tax return, bank statements, deposit slips and stationery;

CC-48 Copies of the statutory notices issued to each petitioner;

CF-49 Copy of government Bond Letter No. 406, dated March 31, 1943;

CG-50 Copy of extract from minutes of the meeting of the Investment Committee of the First Security System of Banks, dated April 20, 1953;

BZ-51 Schedules setting forth the following information taken from the books and records of ANICO and Security Life concerning the sales of credit insurance pursuant to the group policies listed above.

(1) Premiums ceded, claims and claims' expenses with respect to sales of credit life, accident and health, mortgage, twin dollar savings and borrow-by-check insurance.

(2) Total gross written premium, gross written premium attributable to sales of credit insurance to customers of each petitioner-bank; gross earned premium retention by American National net premiums ceded; claims attributable to insurance sold to customers of each petitioner bank.

[(3)] *

C. Preston Allen
Counsel for Petitioners

Lester R. Uretz [MLS]
Chief Counsel

Internal Revenue Service

[* Further and more expanded financial data relative to subjects described in (1) and (2) above.] [JB]

Filed February 8, 1967.

Tax Court of the United States

[*Caption Omitted*]

Transcript of Proceedings

* * * *

Appearances:

[5] Alonzo W. Watson, Jr., C. Preston Allen and Stephen H. Anderson, Esqs., (Ray, Quinney & Nebeker), appearing on behalf of Petitioners;

James Booher, Esq., Internal Revenue Service, appearing on behalf of Respondent.

* * * *

[22] Opening Statement on Behalf of Respondent

By Mr. Booher

* * * *

[26] Respondent's position is that the reinsurance premiums paid by American National to Security Life were excessive. They were more than the amount needed to defray expected mortality costs or other expenses attributed to the business, and allow a reasonable profit for underwriting and carrying the insurance risks.

The excess part of the reinsurance premiums is a commission or rebate earned by Petitioner banks whose lending business generated the sale of insurance, and who controlled the placement of this insurance with American National.

* * * *

[28] Petitioner banks, as I understand it, contend that the provisions of Title 12, USCA 92. prohibit the receipt of any income from the sales of credit insurance. In several prior cases we realize that the courts have refused to attribute income from the sales of credit or other forms of insurance to a lending entity where a State law generally prohibited the lending entity from acting as an insurance agent.

* * * *

[Colloquy Between Court and Counsel]

[48] The Court: I don't think there is any question about the fact that the corporation or individual has a right to—

they would be foolish not to look at the tax consequences of everything they do.

So I think that perhaps Petitioner would admit that every action they take, they look to see what the tax effect is.

MR. BOOHER: They haven't done so thus far.

MR. ANDERSON: We stipulate that it would be a misfeasance of a corporate officer not to be aware of tax effects of his corporation actions.

[49] THE COURT: I should certainly think so. I know if I were on the Board of Directors of a corporation, every action we do I would have counsel in there to tell me what the tax effect would be.

* * * *

[54] THE COURT: I am going to admit them in evidence, but I don't think you can prove your case through these at all. I am not going to give them any weight.

At the present time I don't see that I can give any weight to this kind of argument. However, they are received into evidence, both of those letters, A-Q and A-R, A-Q having been marked for identification.

* * * *

[79] MR. ANDERSON: The Petitioner calls Larry Harlan to the stand.

W. LARRY HARLAN

was called as a witness on behalf of the petitioners and, having been first duly sworn, testified as follows:

THE CLERK: For the record, may we have your name?

THE WITNESS: W. Larry Harlan, H-a-r-l-a-n.

THE CLERK: Your address, please, sir?

THE WITNESS: 9963 Rockbrook Drive, Dallas, Texas.

DIRECT EXAMINATION

By MR. ANDERSON:

Q. What is your business, sir?
A. Insurance.
Q. What company are you associated with?
A. American National Insurance Company.
Q. Incorporated where?
A. Galveston, Texas.

Q. Would you review for the Court the years that you have been in the insurance business and generally what you did in the insurance business?

A. I almost have to tell my age.

I started in the insurance business in 1921 with the rate book at Salina, Kansas.

Two years later I was State Aide of Midwest Life, Lincoln, Nebraska.

[80] In 1927, I became superintendent of agencies of the National Insurance Company. Now they call this job agency vice president.

In 1938, I took over the credit life of the division of the Reserve Long Life Insurance Company of Dallas, Texas.

On October 1, 1949, the Reserve Long Life Insurance Company sold this division to the American National Insurance Company of Galveston, Texas, and since that time I have been manager of the credit life division of the American National Insurance Company, and our operation and headquarters are at Dallas, Texas.

Q. For 30 years now you have been manager of the credit life division of American National; is that right? Is that what you said just now?

A. Or the division before American National was with Reserve Long Life.

Q. How big is American National?

A. American National Insurance Company is I believe the seventh largest stock life insurance company in the United States, with insurance in force in excess of $9 billion, and with total assets in excess of one billion three hundred million, and with capital and surplus funds in excess of $250 million.

The credit insurance division of American National as of December 31st has $1,681 million of credit life insurance [81] in force.

We operate in every state with the exception of the state of New York.

Q. That was my next question.

Does an operation like this take considerable personnel or not?

A. Yes, it does. And maybe this is something we shouldn't talk about. We have very definite ideas as to how credit insurance should be operated in the public interest.

Q. I didn't mean to cut you off.

However, to finish your qualifications out, are you a member of any committees?

A. Yes, I have been a member of the credit insurance committee of the Health Insurance Association of America for a number of years.

I am also a member of the credit insurance committee of the American Investment Bankers of America.

I formerly had other assignments which I now delegated to the general counsel of our division of the company.

Incidentally, he is co-chairman of a morbidity study right at the present time with Yates of the Metropolitan, working in conjunction with the National Association of Insurance Commissioners.

Q. Are you supervising your counsel?

[82] A. Yes.

Q. For the last 20 years have you been on various committees working with the National Association of Insurance Commissioners?

A. I started with the original meetings of the NAIC, studying proposals for the present so-called model credit life insurance bill that is now in force in I believe 38 states and have been very active in helping getting this bill implemented in all the states of the United States, and as a result, for the past 20 years I have been working in some capacity with committees, working in conjunction with various segments of the National Association of Insurance Commissioners.

Q. Is there anything about the credit life insurance business, any material element of it, that you haven't made yourself familiar with in the last 30 years?

A. Credit life insurance business has grown very fast. It has come a long ways in the last ten to 12 years. There are new problems coming up all the time.

Q. Are you generally acquainted with the various aspects of credit life? I don't mean to spend too much of the Court's time on your qualifications. I just want the Court to be aware of your expertise in general.

A. At times we do make mistakes, Your Honor, and I have a beauty that I made in the state of California that [83] cost American National Insurance Company money.

We research this business very thoroughly, but we cannot be right all the time.

Q. During the years 1954 through 1959, was any officers or directors of the First Security Corporation, the First

Security Bank of Utah, the First Security Bank of Idaho, or the First Security Company, of those groups, were any officers or directors of those corporations officers or directors of the American National Life Insurance Company?

A. No, sir.

Q. Was this company an independent, completely independent and separate from the First Security Corporation?

A. Yes, sir.

Mr. Anderson: Your Honor, to save time, in the local finance case to which we have alluded previously at the pre-trial conference, the Government stipulated to a number of general background facts, non-controversial I am sure, which we haven't really had time to stipulate together now.

So, to give Mr. Booher a chance to cross-examine on this, and yet to save time, I would like to read what I consider to be necessary background information for the record, and ask Mr. Harlan if this is correct, and then Mr. Booher can cross-examine if he so desires.

Would that be acceptable to the Court?

The Court: Any objection?

[84] Mr. Booher: No.

The Court: You may proceed, Mr. Anderson.

By Mr. Anderson:

Q. "Credit Life Insurance, insofar as pertinent herein, means single premium term insurance on the life of a debtor with his creditor designated as first beneficiary in an amount at least sufficient to discharge his indebtedness in case of the debtor's death.

"The growth of the credit life insurance has paralleled the growth of the consumer credit, and in the United States most consumer credit is now covered by some form of credit life insurance.

"It is estimated that about 50 million people in the United States are covered by some form of credit life insurance, and the total face amount of such insurance now in force is in excess of $49 billion.

"Credit life insurance is sold usually as an incident to more prominent transaction, namely, a loan of money or installment sale of tangible personal property. It provides a sure, quick and uncomplicated means of liquidating the balance due on the loan or installment sale in the event of

the death of the borrower or purchaser, and to the extent of the benefit paid extinguishes the debt.

"Credit life insurance is written in two different ways. One, under an individual insurance policy issued [85] directly to the insured debtor or, two, under a group policy in which case the beneficiary creditor is the policy holder and the individual insured debtor receives a certificate of insurance.

"The insurance involved in these cases was written on the lives of debtors of the petitioner banks for a term which was co-extensive with the contractual term of the related indebtedness.

"Two plans of life insurance coverage are most generally provided by credit life insurance, namely, one, decreasing term coverage, also called the planning balance insurance, under which the amount of the death benefit decreases during the policy term coincidentally with the decrease under the amount of the debt under the applicable installment payment: and, two, level term coverage under which the amount of the death benefit remains constant during the policy term, a type of coverage particularly suitable where the debt is not payable in regular installments but, for example, in a lump sum.

"For the years here involved and since January—or April 1 of 1954, the bulk, the majority of the credit life insurance issued to the debtors of the First Security Banks was individual, single-premium, decreasing term life insurance under a group policy, issued to the bank."

That is, the debtors received certificates when they [86] took out insurance.

"During this period of time, and since January 1954, a certificate evidencing this insurance was issued to each of such debtors purchasing the policy.

"Under a normal credit life insurance policy, the creditor is the primary beneficiary to the extent of the unpaid balance of the indebtedness at the time of the insured's death.

"If because of prepayment or some other reason the amount of the death payment payable under the policy should exceed the balance due on the account, the insured's designated secondary beneficiary receives the excess. Such provisions were applicable to the insurance coverage obtained by borrowers from Petitioner banks herein.

"The premium due for the entire term of the insurance

company on the lives of the debtors of the Petitioner banks was paid in a lump sum at the inception of the coverage.

"In the event the loan was paid off in advance, in some instances the insurance was terminated and a refund of the premium allocable to the unexpired portion of the old loan was made."

That is, Your Honor, whenever a loan ceased to be outstanding and there is still insurance coverage in force, there would be a refund where appropriate, or if there was a cancellation there would be a refund where appropriate.

[87] "If the loan was refinanced by a new loan and new life insurance was written on the new loan, the insurance on the old loan was always terminated and the premium allocable to the unexpired portion of the old one was refunded or credited to the premium on the new insurance.

"During the years here involved and since April 1954, the premium charged by the American National Life Insurance Company to the Petitioner banks' debtors was one dollar per $100 coverage per year on decreasing term insurance. This rate was the rate commonly charged in the credit life industry in Utah, Idaho and in Texas, the states involved in this suit all during the years in suit."

Is what I have just read correct, sir?

A. Would you read me the first paragraph again?

Q. The very first paragraph?

A. Yes.

Q. "Credit life insurance, insofar as pertinent herein, means single premium term insurance on the life of a debtor with his creditor designated as first beneficiary in an amount at least sufficient to discharge his indebtedness in case of the debtor's death."

A. We had one type of coverage in the First Security Banks, and this was this double-dollar savings that was on monthly outstanding balance.

Now, on all the insurance written on debtors, it was [88] all single-premium.

Q. With that change, would what I have just read be correct?

A. Yes.

Q. Tell the Court what led to your initial contacts with the First Security Corporation, what those contacts were and what came out of those contacts, as briefly as possible, would you, please?

A. Well, it all went back to the summer of 1953, attending

a midyear meeting of the American Finance Conference in New York City.

And the chief topic on the floor of the members was why did CIT organize Patriot Life Insurance Company of New York.

Well, when CIT had organized Patriot Life I happened to have been familiar when Occidental Life was organized in this state, and I had some friends who wrote some of the first life insurance policies with Occidental Life with the cooperation of the managers of the Bank of America.

So what I am saying is that where any firm has lots of debtors, doing business with lots of people, these are very good prospects for life insurance.

Of course, at that time the laws were very favorable, tax laws, to a life insurance company as well, but some of the main things are that if you are successful in building a [89] life insurance company, you have that terrific premium income available for investment.

So I came back home, and I talked to our management. I said, "We have got to make up our minds. Unless we can come up with some idea, we might as well forget all of our big credit life accounts because I think the handwriting is on the wall, they are going to start organizing their own life insurance companies."

So, making use of our various departments, our legal departments, our actuarial department, and what-not, we came up with an idea and the idea was this. We went to our big clients, and we said, "Look, if you want to develop a life insurance company we will make the brains of the manpower of the American National Insurance Company available to you to aid and assist you to build this company."

And as a result, today we are operating the books and advising and counseling with people that own in excess of 60 life insurance companies, and we added more new life insurance companies to this group last year than any previous year since it started in December 1953.

Do I need to say——

Q. What happened when you went to First Security Corporation with this idea?

A. I had been trying to do business with First Security Corporation for several years, and they were doing business [90] with other companies.

One of the first banks in the West that came with us

was the Valley National Bank of Phoenix. They came with us in December of 1963. Naturally we called on other outstanding banks in the area, and the First Security Corporation was on the list.

I talked to Mr. Owens Thurman, who in turn took me to Mr. George Eccles, and I told Mr. Eccles why I thought it was to the interest of their organization as to the ownership of a life insurance company.

Q. Tell the Court how long the corporation considered what you told them before they took any action.

A. I think it was probably a six-month period.

Q. Did the spring of 1963—strike that.

Was it from the spring of 1953 until April 1st of 1954?

A. No, I didn't say the spring of 1953. I think probably the first time that I talked was either the fall of 1953 or after the first of January of 1954.

The Court: Then what action was taken?

The Witness: They decided to organize the life insurance company. They decided to make use of the personnel of American National Insurance Company to operate the life insurance company for them.

[91] By Mr. Anderson:

Q. Was a life insurance company then formed?

A. Yes.

Q. Was that the First Life Insurance Company of Texas that we are talking about in this suit?

A. Yes, sir.

Q. Was that corporation submitted at its inception for approval to the insurance commissioners of the state of Texas, or reviewed by them at the end of that year?

A. Number one, you have to get the approval of the Board of Insurance Commissioners before you get a charter granted. After the company, it was activated, then—back in those days, under the Texas laws, it had to be examined at least once every two years, and it was so examined.

Q. Has there been any criticism from these examinations?

A. To the best of my knowledge we have never had criticism on the operation of any of the companies. Also, we operate for clients on this program.

Q. Do you file annual statements for the Security Life of Texas with the Texas Insurance Commissioners?

A. Yes.

Q. All during the years 1954 through 1959, was that correct?

A. Yes.

Q. Tell the Court if there is any difference between [92] having a life insurance company and having a life insurance agency.

A. Well——

Q. Are they the same thing?

A. There is no comparison at all. A life insurance company is taking a risk every time they issue an insurance contract, or if they enter a reinsurance treaty from some other company that has issued the risk.

An agency has to be, of course, licensed by the proper State authorities, and it has contracts to go out and offer insurance for sale on a commission basis. And so the income of the agency is totally based upon their ability to sell insurance under the terms of the agency contract they have with a life insurance company, whereas a life insurance company, its source of earnings are from underwriting profits, if they are smart in selecting risks.

And if they are smart in making—or investing profits.

Q. Is there any guarantee that a life insurance company is going to make a big profit?

Mr. Booher: I object to that as being argumentative.

Mr. Anderson: I withdraw the question.

By Mr. Anderson:

Q. What kind of profit would a life insurance company expect to make?

[93] Mr. Booher: If this is relevant to this case, I suggest that it would be more specific so that answer would be more relevant to a company of the type similar to the ones that are in issue in this case.

By Mr. Anderson:

Q. In 1954, what kind of profit would Security Life of Texas expect to make, big, little, or medium?

A. In the first year of its operation, it was problematical whether it would make any money at all.

Q. Was there any way of telling whether it would make money or lose money?

A. No, sir.

Q. Under the life insurance policies issued by American National Life Insurance Company during the years 1954 through 1959, these group policies we are talking about which are in evidence, was there any legal relationship between American National Life Insurance Company and the policyholder?

A. The policies were written, and the policyholder was a policyholder of American National Insurance.

Q. Who would the policyholder look to?

A. American National.

Q. Was there any obligation from Security Life to American National under the insurance?

A. Security Life would have to reimburse American National for all claims paid.

[94] Now, if by any chance Security Life did have the funds, American National would still have to honor the policy, the terms of the policy contract.

Q. If for some reason Security Life of Texas refused to pay on claims submitted by you, would you consider suing them to get those claims?

A. I would sue them.

Q. Security Life of Texas, as shown by exhibits in evidence, received 85 percent of the standard rate charged, that is, these premiums, less cancellations, as its payment for insuring a hundred percent of the risk.

Now, in your expert opinion, did Security Life of Texas need that amount to operate on a sound basis?

A. I think I have already answered your question. I told you it would.

Q. It would?

A. Yes.

Q. About what margin——

A. May I say this. I have some companies that have attempted to pay some commissions in the past 12 months, and without exception we have had to call upon them to contribute additional surplus.

Q. Very well. The Judge has heard how big American National Life Insurance Company is. About what margin of profit does your company operate on?

[95] A. Less than five percent.

Q. Did Security Life Insurance Company of Texas have that volume of business to stay on a sound basis?

A. No, they don't have sufficient volume of business.

Q. Is there any financial similarity between the two companies, any comparison?

A. There is all the difference in the world between a small country grocery store and a big super market, and you have got the same thing here, Your Honor.

Q. During the years 1954 through 1959, was it the exception or the rule to have reinsurance companies like Security Life operating in the financial world in the business of finance?

MR. BOOHER: Object to that as being argumentative. If we are to show the practices, what the practices were, we should have more definite information in the form of statistics.

MR. ANDERSON: What the Government is trying to do here is put us into an unusual situation. I want to erase from the record that what we are doing is unusual, rare or strange.

THE COURT: He may answer.

By MR. ANDERSON:

Q. Will you answer, sir?

A. With the exception of the largest finance company of the United States, practically every other company of any [96] size owns a life insurance company, and some own more than one life insurance company, such as Commercial Credit.

Q. Did the Credit life insurance business operate on a volume basis, still being comparatively young in 1954?

A. Yes.

Q. Were rate losses fixed and known at that time?

A. Would you want me to enlarge upon that?

Q. Yes, briefly.

A. The credit insurance business is a new business. It wasn't too many years ago that we had very few laws regulating the credit insurance business, Your Honor. It was unusual for a creditor to buy insurance wholesale, and then charge as much as he could for it.

In fact, some of our great big banks charge two and a half times the cost of the insurance, and these things are on record.

There were cases when in the event of refinance, prepayment, they never cancelled the insurance. There were cases—we had one case in Austin, Texas, where a little

insurance company sold policies for 12 and a half cents apiece with the understanding there would never be a claim.

Q. Summarize.

A. This is what brought together people working with the insurance commissioners, and this is where the medical credit life bill came into being, which is now being passed by 38 [97] states, and included other states this year.

Q. Were loss ratios and rates fixed and known at that time?

A. Loss ratios ten years ago were absolutely meaningless.

Q. Do mortality rates vary in the credit life business?

A. Definitely.

Q. There is no one set percentage of mortality?

A. I wish there was a book that could give us an answer. There isn't.

Q. On the business that American National was involved in with the First Security Corporation, the Petitioner banks, and Security Life of Texas, during these years in suit, were there any health requirements for the people who got the insurance?

A. No, sir. Even though the man maybe had cancer, if the insurance was issued we made the claim when he died.

Q. Was there any waiting period before the insurance went in force?

A. None. We are trying to clear this up in the industry, Your Honor, right now.

Q. Would this situation have any effect on mortality rates?

A. Certainly.

Q. Bad or good?

[98] A. If you write a very restrictive cover——

Q. You didn't understand. Does the situation of not having health requirements, not having waiting periods, affect the——

A. Certainly, your loss ratios are much more.

Q. Could Security Life have begun alone as a full-line direct writer on the capital it had?

A. Impossible.

Q. Was it possible to use managerial service, the managerial service of American National, as to all of the personnel, in order to operate on a sound basis?

A. Or some other.

Q. Could Security Life have duplicated services offered

by American National, that is, staff its own office and get its own actuaries, and for the same amount of money that it paid American National to perform those same services?

A. To attempt to staff their own company would have cost more than 50 percent of the annual premium that was originated in the first year or two.

THE COURT: Then your answer was no?

THE WITNESS: Yes, no, Your Honor.

By ANDERSON:

Q. Well, my next question would have been how much more would it have cost, and you have answered that.

Is it common and accepted for a direct writing [99] insurance company to start out as a reinsurance company like Security Life of Texas?

A. There have been a number of cases, yes. In fact, we have some cases where companies that started out as reinsurance companies are now writing life insurance direct.

Q. Have you had conversations with the officers of First Security Corporation during the period of your first contact with them on, and have they had conversations with you about the expansion of the First Security Life Insurance Company of Texas?

A. This was talked about in our first interview, and it has been talked repeatedly ever since.

Q. That is the expansion into whole direct line writing?

A. Expansion of First Security Life into all phases of life and casualty insurance writing.

Q. Just a couple of more questions.

During the years 1954 through 1959, did American National have any contract of any sort, of any shape or nature, with the First Security Company, the management company?

A. No.

Q. Did it have any contract or agreement of any sort with the employees of First Security Company?

A. No, sir.

Q. Other than the group policies in this suit, did [100] American National have any agency agreements or contracts, or any other agreements of any sort, with the Petitioner banks in this case?

A. No, sir.

Q. Or the employees of those banks?

A. No, sir.

Q. Was there any legal connection at all between American National Life Insurance Company and the First Security Company, or the First Security Banks of Utah and Idaho, other than the group policies on the banks?

A. No, sir.

Q. Can just anyone form a company like First Security Life?

A. No, sir.

Q. Would you, as an associate of American National, allow your management services to be purchased by just anybody, forming your national company?

A. We have said no to a number of people, coming to us because they did not meet our requirements.

Q. How would you say that American National's management services compare with other large life underwriting companies?

A. You shouldn't ask me that, because I would be prejudiced.

Q. Can we agree that you think they are srperior?

[101] A. As long as our clients think they are, that is all I am concerned with.

Q. The Government in this case is suggesting that part of the money which Security Life got in the years 1954 through 1959 was some sort of commission.

Do you know of any law or regulation or practice in the insurance business which dictates that a certain part of the premium rate is or must be a commission?

A. There is no such law that I know of.

Q. Is there any standard commission in the insurance industry out of every premium rate?

A. No.

Q. Do commissions and rates vary throughout the industry?

A. Yes, sir.

Mr. Anderson: That is all I have. You may cross-examine.

The Court: Cross-examination?

Mr. Booher: No questions, Your Honor.

The Court: Thank you very much, Mr. Harlan. You may be excused, and you can step down, sir.

(Witness excused.)

[116] Mr. Watson: Your Honor, Petitioners would like to call as their next witness, Mr. George S. Eccles.

George S. Eccles

was called as a witness on behalf of the Petitioners, and, having been first duly sworn, testified as follows:

The Court: For the record, sir, may we have your name?

The Witness: George S. Eccles, E-c-c-l-e-s.

The Clerk: Your address, please?

The Witness: 1525 Penrose Drive, P-e-n-r-o-s-e, Salt Lake City, Utah.

Direct examination

By Mr. Watson:

Q. Mr. Eccles, you are an officer and/or a director of [117] each of the Petitioner companies in this case; is that not correct?

A. I am.

Q. And you were during the years 1954 through 1959 an officer and/or a director of each of these Petitioners?

A. Yes.

Q. And are you also an officer and director of the First Security Corporation?

A. Yes.

Q. And were you an officer and a director of First Security Corporation during the years 1954 through 1959?

A. Yes, sir.

Q. Would you explain the relationship between the three Petitioner corporations and the First Security Corporation?

A. That's the two banks and the holding company; is that right?

Q. The two banks and the management company?

A. First Security Corporation——

The Court: For the record, the management company is the First Security Company—or corporation?

Mr. Watson: No. The management company is the First Security Company.

The Court: Right.

By Mr. Watson:

Q. Shorten it this way, and let me ask you directly, [118] are the three Petitioner companies subsidiaries of the First Security Corporation?

A. They are.

The Court: That's better.

By Mr. Watson:

Q. Give a short description of the history of the First Security Corporation.

A. The First Security Corporation is a bond holding company qualified now under the banking Act of 1956 as a registered bank holding company.

The First Security Corporation was organized in 1928 or '29 and the banks mentioned are subsidiaries of the First Security Corporation.

The First Security Company is a service corporation rendering service to the banks and a wholly owned subsidiary of the First Security Corporation.

The First Security Corporation is a Delaware corporation.

It is not even qualified to do business in Utah because it is particularly a holding company of the stock of the two banks and the First Security Company, along with other subsidiaries.

Q. Give us a little history of the development of the First Security Corporation?

A. The First Security Corporation is the oldest bank [119] holding company in existence, recognized by the comptroller of the currency in his annual report to the Congress of 1928.

At that time there was a group of banks owned by the people that started First Security Corporation and we p... them all into one corporate entity, took stock,—the owners of those banks took stock in the holding company.

We started out with about, oh, a very few banks and then in '33 you had a branch banking legislation passed in Utah and Idaho and the independent banks were thrown together in one branch in each state.

That was in 1933. Now, the subsidiaries, consists of four banks with 101 banking offices, extending from the Canadian border through to the Arizona border throughout

Utah and Idaho and one independent bank in Rock Springs, Wyoming.

Q. In these early years from 1954 through 1959, did the First Security Corporation also have other non-banking affiliates?

A. Yes. They had savings and loans. They had the Company, Ed. D. Smith, which was an insurance agency, having been the general agents for Aetna Casualty Company for over 20 years.

I think during those years we acquired First Security Insurance agency of Idaho in conjunction with acquiring a bank in Idaho sometime during that period.

Q. Let me ask you this.

[120] What was the attitude inside the corporation?

Was the corporation expanding its operations all of the time?

A. Very definitely.

We organized during that same period a Security Savings and Loan with five offices, three in Idaho and two in Utah.

We endeavored to acquire other types of financial operations.

We were desirous of having—of going into the life insurance business.

Well, we are desiring of expanding any way we could under a central holding company that had sufficient financial base to go into all types of the financing field.

Q. What is the management's structure of First Security Corporation? How is it operated? Through what——

A. The First Security Corporation, the parent holding company, has had from 25 to 30 directors during its entire existence, very representative directors of industry and finance.

They meet quarterly. The First Security Corporation through its Board of Directors is—has appointed an executive committee with power to act between board meetings.

They act for the board and any legal actions taken by the executive committee is reported to the board at the [121] quarterly meeting for board approval.

The executive committee also meets in an informal capacity oftener than they do in the so-called legal capacity and then it is somewhat of a policy type board.

The minutes are not—they don't go into the general—I mean, the minutes, they are merely memorandums is all they are.

Q. Has the corporation also attempted to obtain as members of its board, outstanding men in business and finance in the inter-mountain area?

A. Well, not only the inter-mountain area, because our influence, we feel, goes beyond the inter-mountain area.

We participate in national company credit lines and that and so we expand our board very much.

Today, for example, we have and have had the president of Union Pacific, headquartered at Omaha; the president of the Rio Grande and Denver Railroad; we have the presidents of two of the largest lumber and plywood and paper companies which includes the president of Potlash Forest, one of the largest lumber and paper companies in the country.

They have a huge mill in Lewiston, Idaho, but his headquarters are in San Francisco.

We have the head of the Boise Cascade. That is one of the national companies, one of the large ones in lumber and paper, the lumber and paper industry.

[122] Their headquarters are Boise, Idaho. We have the president of Utah Construction Company and his headquarters are in San Francisco.

We have the head of the Utah Copper Company—I don't mean that. I mean the Utah Power and Light Company. We did have the head of the Utah Copper Company at that time.

Q. During these years 1954 through 1959, you had similarly representative men?

A. All of the time, ever since it started.

Q. Would you explain to the Court how your boards of the two banks are constituted?

A. The legal board of directors of the two banks is made up of the senior officers of the two banks, not overlapping, except in my particular case.

I happen to be on the board of the Idaho bank and the board of the Utah bank.

We have senior officers of the banks and the member of the executive committee of the First Security Corporation on the Utah board.

Then we have a board that we call an advisory board in the Utah picture. They consist of representatives citizens and would act as the same as a Board of Directors of any other bank, but being a branch system, you don't take a day or two of their time to go over all the matters in the branches of the four corners of the state.

[123] You do that legally under the National Bank Law. That is, you do that through your official Board of Directors. But, as to Salt Lake and Ogden and the major parts not only go to this board of directors but go to this advisory board.

Many of those advisory board members are also directors of the First Security Corporation.

Q. Does a director of a national bank have any special obligations or duties?

A. I would think very definitely he does. It is set forth in the National Banking Law. It is very detailed and you have very grave responsibilities.

Q. Could you name some of these restrictions?

A. Well, you are required to approve the loans that are put on by your loan officers, identify them by number, review them once a month.

You are required to have a member of your board as chairman of your trust committee or your trust department.

You are required to own, unpledged, just a normal amount of stock, but that is one of the requirements of the law.

You are responsible for the soundness, the proper operation of the banking institution. And if you violate any provisions of the law, of the banking law, it sets forth very grave penalties and not only that, but it gives the right of the banking authorities to ask for your removal.

[124] Q. Mr. Eccles, are you now on the comptroller's advisory staff?

A. I am and have been since Mr. Saxson set it up.

Q. During your years as a bank officer and bank president, have you worked closely with National Banking Associations?

A. Very definitely.

I have held many positions with the American Bankers Association, all through the years. I have been head of their economic research department. I have been a member of the legislative committee.

I have been a member of their economic educational group.

I have been a member of the Reserve City Bankers Association which is an inner group made up of the 200 largest banks, representatives from those banks.

They happen to be the senior officers. In fact, I am the oldest member in years of service of that organization.

There are about 350 members. I have chairmaned four committees during the period I have been in there.

I have been in since 1926. I have been vice-president and I have been president of it. I have been chairman of the Credit Policy Committee and I have been chairman of—and now am a member of their legislative committee.

Q. In connection with your banking interests, have you [125] also made studies in different foreign countries?

A. The year I was president of the Reserve City Bankers Association, the president of American Bankers Association and I made a trip through South America, meeting with the different bankers of those countries, studying the economic and the banking picture of the various South American countries.

The American Banking Association have promoted for 11 years—I was one of the original members of this group and am still a member, what they call the A.B.A. International Monetary Conference.

We meet in the states one year. We meet abroad one year. We have the heads of the central banks of Europe.

We have about 35 of the top leading banks in the United States representative senior officers. And two or three years ago I was general chairman of the conference in Vienna, Austria.

This year I am chairing the second day's session of that particular meeting which will be held in California in April.

Q. Are you an officer and director of First Security Life Insurance Company?

A. I am.

Q. Were you an officer and director of that company during the years 1954 through 1959?

A. Yes.

[126] Q. Did you participate in discussions leading to the incorporation of First Security Life?

A. I did.

Q. Would you explain to the Court how—or what considerations were involved in making the decision to organize the life insurance company?

A. As I have said in my earlier testimony, we were anxious to expand the operations of the First Security Corporation through its subsidiaries.

We felt that a life insurance company was a very beneficial adjunct to our entire operation.

We felt that a full line company was very beneficial. I

had had some experience with so-called baby life companies in that I was one of the original stockholders and still am, and a director of the American Bankers Life Company of Florida.

I could see that in a general life company, properly operated, it was a very profitable type of operation and the investment in that company and the American National at a later date has proven that it is very profitable.

However, we just wanted to expand and give service of all types, financial service.

We have even tried to go into the small loan field. We have even tried to go into many other types of business.

Q. Were there ever business considerations besides the [127] life insurance, the full line direct writing insurance company business?

A. Yes. We had a very active consumer credit department and we call it Time Way. It is one of the largest in the inter-mountain area. We finance the purchase of automobiles. We finance under Title 1 FHA.

We finance personal loans, all type of consumer credit.

And along at that time it was necessary to offer the borrower a protection. We call it Credit Life. He was insured for the amount that he was borrowing on a diminishing basis as he paid back the loan, the insurance would go down.

However, if he died during the life of that loan, the loan would be paid off by the insurance that he was carrying.

Then in the mortgage field, along about that same time, and I guess it is because you got into long-term mortgages under GI and FHA programs and so on, you wrote what we call mortgage cancellation insurance.

It was a policy on the individual. It was a fixed amount of 10,000 in Utah and 5,000 in Idaho to start with because that was the state law.

However, as the mortgage was paid down to the amount of the insurance, then it became diminishing term insurance from then on out.

Q. Let me interrupt you a minute.

Did you also take into consideration such things as [128] the——

Mr. Booher: I believe he will be leading the witness with this type of questioning.

The Court: Yes.

The Witness: Well, I was going to continue——

The Court: Yes.

By Mr. Watson:

Q. Were there other considerations, if any?

A. Very definitely. I was going to get to that.

As you build up your insurance company, the insurance company is not restricted on the type of investments which it can make the accumulated assets. It may go into stock which a bank can't do.

It can go into types of bonds which a bank can't do. It can handle mortgage servicing which our company did out of California, originated mortgage there and sold them to Eastern investors and did the servicing for them over the life of the mortgage.

You might say a bank is very restricted in what it can invest in while a mortgage company is not nearly as restricted.

Q. Mr. Eccles, in your opinion, would the First Security Corporation have organized the life insurance company in 1954 if it then felt that the company would not develop into a full line direct writing company?

[129] A. Oh, we thought right from the start that we would develop into a full line company.

Q. Would you have organized it unless you thought you could have gone into a full line direct writing company?

A. Well, you wouldn't have been so anxious to start it, I know that. It is pretty hard to say—I don't think you would, no, because it wouldn't have given you the scope. You couldn't develop into the size that you had thought at the time that you had started it that you were going to be able to develop it into.

Q. Why is it that First Security Life Insurance Company has not become a full line direct writing company then?

A. Because of the bank holding company Act.

I can go back on that.

I have been active on the bank holding company group since we started in 1928 and all during the period of the '30's the late '30's, the '40's, in which there was discussions in Congress in committees on proposed bank holding company legislation.

Nothing developed until the banking Act of 1956. However, from '50 on, every time the banking currency com-

mittee of the House and the Senate would meet, they would bring up possible proposed legislation which meant separating non-banking subsidiaries from sub-banking subsidiaries of the bank holding company.

[130] So, at that time we didn't know what would be the outcome of our non-banking subsidiaries which included the First Security Life.

Also, included the Saving and Loans and so on.

Q. Were there other reasons, if any, why the life company has not developed into a full direct line insurance company?

A. I don't think so. It couldn't, under the holding company, apparently, and I—by '56 we knew we couldn't.

Q. There were no other reasons that inhibited this life insurance company?

Mr. Booher: The witness answered the question. There were no other reasons that he knows of and this should terminate the matter.

I object.

The Court: Have you finished your answer?

The Witness: I think I have.

The Court: Next question, please.

I haven't acted on your objection. Let me hear the question rephrased or get into your next question, Mr. Watson.

By Mr. Watson:

Q. I asked him if there were other reasons, if any, why the plan to create a full direct line life insurance company was not carried out?

A. May I answer that?

The Court: Yes. You can answer yes or no.

[131] The Witness: Yes.

The Court: Any objection?

Mr. Booher: I object to the question. The witness previously stated he knew of no other reasons and that should end the examination on this point.

By Mr. Watson:

Q. Have you now had an opportunity to think about it a little more?

A. Yes.

Mr. Booher: The Court hasn't ruled.

THE COURT: I am going to overrule the objection and realizing at the same time that the weight that the Court would give to this next answer is judged by virtue of the way it is developed.

You may answer.

THE WITNESS: I don't know. I didn't think of it, but I happened to be sitting in a tax court and the reason is a tax reason. Our tax returns were still open from 1950 on.

We couldn't very well merge with whole line life companies which would be your normal means of expanding a credit life company into the whole life business because we didn't know our tax liability.

It would be hard to appraise the company, so you could arrive at a proper valuation.

We didn't know whether we were going to be considered [132] as a life insurance company.

There were many questions being raised as to whether a credit life company is a life insurance company. I understand that has been determined in some courts that they are.

The whole thing is of such a flux that you didn't know from the bank holding company Act if you could do it. You didn't know from the tax picture whether he would arrive at a valuation, so those were the reasons we sort of marked time with the First Security Life Insurance Company.

By MR. WATSON:

Q. As a result of the bank holding company Act, was it necessary for the First Security Corporation to dispose of the stock of the First Security Life Insurance Company? Just yes or no?

MR. BOOHER: This is calling for a conclusion of law on the part of the witness. The bank holding company Act contains very specific statutory language, concerning what subsidiary companies may be retained by a bank holding company or must be spun off, so to speak.

THE COURT: The objection is sustained.

I am not precluding you to arrive at it by virtue of another or different question.

By MR. WATSON:

Q. Did the First Security Corporation, in fact, dispose of the stock of First Security Life Insurance Company?

[133] A. Well, there was a separation. It didn't go quite that way. That isn't the way it was handled, if I could explain how the split was made?

THE COURT: Yes.

By MR. WATSON:

Q. Go ahead and explain what happened.

A. The bank holding company Act in 1956 gave us a certain number of years to divest non-banking affiliates.

The Transamerican Corporation was the first one that had gone through that type of divestment.

And they had had hearings before the Federal Reserve Board which is required by the bank holding Act.

And they were required to spin off Occidental Life along with their other non-banking affiliates.

So our counsel and I went back, met with the Federal Reserve Board. They told us there was two ways in which we could do this. One would be to spin off our banks and the First Security Company which is the bank service company which is specified in the bank holding company Act is similar to a bank in being able to retain it, or we could spin off in a separate corporate entity the other companies.

However, if we did that, then we would have to go through the complete hearing.

What we did, at the suggestion of the counsel for Transamerica, our own counsel, after our discussion with the [134] Federal Reserve, we organized a new holding company. We put the banking entities and the First Security Company into the new holding company.

We distributed that to the stockholders and we retained in the first so-called old First Security Corporation, all of the other subsidiaries that we had.

Now, by splitting everything right down the line like that, the Federal Reserve didn't ask for a hearing. And had you had a hearing, you had to have a hearing on every subsidiary, not only the First Security Life, but on every subsidiary.

And they had to certify to you a spin-off before you could get a tax ruling which made the spin-off a tax free divestment, so that is the way we—then the name of the First Security Corporation was changed to First Security Investment Company and the new spin-off company carried the name First Security Corporation, owning nothing but the banking entities and the First Security Company.

Q. Then is your testimony that after——

MR. BOOHER: I will object to counsel's summarization of the witness's testimony.

THE COURT: Sustained.

By MR. WATSON:

Q. Does the First Security Investment Company now own all the stock of the First Security Life?

[135] A. Yes.

Q. Has it owned all of that stock since September of 1959?

A. Yes.

Q. Are you a member of the board of directors of the First Security Investment Company?

A. I am.

Q. And have you been since the middle of 1959?

A. Yes.

Q. And since 1959, has there been any expansion and contractions in the types of investments held by First Security Investment Company?

A. There has.

Q. Would you explain what those are?

A. Three or four years ago, we purchased the controlling interest in F.I.F., that is Financial Industrial Fund, a mutual fund management company, located in Denver, managing a mutual fund of about $290,000,000.

We retained that for several years, but we found that during that period it was headquartered in Denver. It required a lot of extra effort and we didn't feel we were making out to that what we were justified in making and we finally sold it to the Gate Rubber people of Denver.

Then we purchased 51 per cent of Security Leasing Company, a leasing company, headquartered in Salt Lake, but [136] operating throughout the United States, having about $15 million of leases outstanding.

We retained the majority interest in that company at the present time.

Q. In 1959——

THE COURT: I don't believe he was finished.

Were you finished with your answer?

THE WITNESS: No. The largest in New York, Aubrey, A-u-b-r-e-y, Glanston, G-l-a-n-s-t-o-n, Company deals strictly in Government bonds.

Through our various interests, we have been a small holder in that company since 1939. The owner, that is, the head of it, the one that started it, Mr. Glanston, contracted cancer, lung cancer, and knew that his time was limited, so he offered to sell to us a much larger percentage of that company, and First Security Investment Company bought that and now own it.

I am chairman of the executive committee and active in the actual operation and functioning of that Government bond house.

By Mr. Watson:

Q. Let me ask you this.

In 1959, did the First Security Life Insurance Company pay a dividend to the First Security Investment Company?

A. Yes.

[137] Q. And approximately how much——

Mr. Booher: We will stipulate that a dividend of $398,000 was paid during the year 1959.

The Court: Is that agreeable?

Mr. Watson: Yes.

By Mr. Watson:

Q. In your opinion, has there been a considerable change in the stock holdings of First Security Investment Company since 1959?

The Court: Let me have the question so I can rule.

Read the question back, Mr. Reporter.

(Record read.)

The Court: You object?

Mr. Booher: It isn't an objection in a sense. I believe counsel mentioned in the opening statement that we don't have detail information concerning this change in ownership and so the record will be left open to get this information.

If it please the Court, I would appreciate a few minutes with—I would appreciate a few minutes recess to talk this over with counsel off the record to see what the most expeditious way is in working this out.

My understanding is that we were not going to have testimony with respect to these estimates, that we would get an actual physical count of the change in ownership.

Mr. Watson: Well, I will withdraw the question and

[138] we will leave the record open for the purpose of finding out.

THE COURT: Do you want a yes or no answer to it or do you want to skip it?

MR. WATSON: I will just withdraw it, your Honor.

THE COURT: All right.

By MR. WATSON:

Q. Mr. Eccles, in your opinion as a stockholder, director and officer of First Security Investment Company, would either First Security Investment Company or First Security Life pay over to any of the Petitioners the income which is asserted to be taxable to the Petitioners if this Court hold such income to be taxable to Petitioners or any of them?

MR. BOOHER: Before the witness answers, I will make an objection to that question.

I understand Petitioners' position to be that it is illegal for any such payment to be made.

If that is their position, then the development of that position is a matter of argument, is a question of law, and does not require any testimony from the witness.

THE COURT: Are you asking from the standpoint of a legal conclusion or his opinion as not from the legal standpoint, but from the business standpoint?

MR. WATSON: From the business standpoint as an officer and director.

[139] MR. BOOHER: If your Honor please, if his sole purpose is his business opinion, from the legal standpoint that would be irrelevant from the argument raised by Petitioners.

THE COURT: I am not so sure. I am going to let him answer from the business standpoint, but I caution you to stay away from any legal aspect of an answer.

I don't want you to say, "The law reads so and so."

If you have had meetings with your legal staff and you have been advised of thus and so and based on that, you have concluded that "we shouldn't do it from a business standpoint or other standpoints," this is all right.

THE WITNESS: The answer is yes.

By MR. WATSON:

Q. Have you discussed——

A. It would be illegal—in my business judgment, my judgment as that I would not have them pay anything into the banking system.

MR. BOOHER: I move to strike the last answer of the witness since it involves the question of the legality of the payment.

THE COURT: It is stricken insofar as he said it would be illegal, but the rest of the answer will stand.

Have there been any meetings with your legal staff regarding this situation?

THE WITNESS: Yes.

[140] THE COURT: Has your legal staff advised you on this matter?

THE WITNESS: Yes.

THE COURT: What advice did they give you?

THE WITNESS: That it could not be done.

THE COURT: Did they advise you that it would be illegal?

THE WITNESS: In their interpretation it would be illegal.

THE COURT: This answer will stand.

By MR. WATSON:

Q. Are the First Security Bank of Utah and Idaho as national banks chartered and authorized to function under federal laws?

A. They are.

Q. Are they subject to supervision and control by federal agencies?

A. They are.

Q. What are these agencies?

A. The comptroller's office of the National Banking Division, the Federal Reserve Bank of the Federal Reserve System of which we are a member and one other on top of that, by the Federal Reserve under the terms of the bank holding company bill.

Q. Did these agencies make regular inspections?

[141] A. The National Banking Department makes the examination for both the National and the Federal Reserve and so far as the banks are concerned, the Federal Reserve makes examination of the parent holding company.

Q. What is the purpose of these examinations?

MR. BOOHER: I object. That is a statement of law.

They are making these examinations pursuant to statute duly constituted federal authorities.

THE COURT: You may be heard.

MR. WATSON: Your Honor, as an officer and director of a national bank, he certainly knows what purpose the comptroller's men make these examinations, what they are in there for, what to look at.

THE COURT: Let him state what his opinion is.

Of course, if the law is to the contrary, I will be bound by the law, not this witness's impression of what—I will let him answer.

THE WITNESS: They make two examinations a year, normally, and sometimes three in two years.

They go through your credit pouch very definitely to make sure you are complying with the requirements of the national banking law and the types of credit you make.

As to the amount, you have certain legal limit restrictions as set forth in the National Banking Act on the regulations of the comptroller. They check for that. They [142] check the credit statements to determine whether your credits are desirable assets for the bank.

They check your bond account. They check entirely through your trust department. It takes about, in our system, over a month and a half to complete the examination of either one of the two state banks.

By MR. WATSON:

Q. Well, are they looking for violations in the national banking laws?

A. Very——

MR. BOOHER: I object to that as calling for a conclusion of law.

It is also hearsay to learn what the purpose of the bank examiners are.

THE COURT: It is leading, but I will overrule the question. Obviously they are. Let us see this account and let us see that account.

I will overrule the objection, but try and watch the leading questions, counsel.

Anything that the examiners have done or any of the boards coming in to examine the banks, all of that is proper testimony.

THE WITNESS: There is one question in the examination report that asks that if we know of any violation by any officer or employee of the bank, that could have occurred

and [143] we have to certify to that and if we do know of any, we have to give a complete report.

And if we don't give it, we are hiding evidence, you might say, and we are as much liable as the guilty person, so——

By Mr. Watson:

Q. If these violations are not corrected, what can happen then?

Mr. Booher: Again, I would object.

He is asking for an answer which involves the application and interpretation of the National Banking Laws.

It is calling for a legal conclusion. If it does not involve this, the answer would have no substance or meaning.

Mr. Watson: Again, your Honor, as a businessman and in dealing with these people regularly, he knows what——

The Court: I think he can ask the question, if you don't comply, are there penalties?

I think he can answer that one, but if he becomes very speculative after that—obviously there are penalties?

The Witness: Yes.

The Court: Is there anything further you need on that?

Mr. Watson: That's all, your Honor.

The Court: I mean if there have been situation in the bank where the penalty was proposed by the examiners or [144] they came in and said, "Now, this is a strange transaction here and you are aware of such and such a penalty," this is proper testimony, but I don't think you can speculate as to what they might do.

The Witness: This is what they do do in actual practice up to a point. From then on I have had no experience.

Any violation or any unsound banking practice, they write up in the examination report and the report is not sent to me as president of the bank. It is sent to the Board of Directors of the bank.

It sets forth very definitely. And they ask for corrections and if it isn't corrected, then they come in. And I know of one national bank institution by experience in Salt Lake City that we were not interested in, but the case is in the record and they have had many, many hearings and the Federal Reserve comes in and assists the National Department and they try to expell them from membership in the Federal Reserve and so on.

However, the San Francisco National over here was a typical example.

Here are great penalties and all you can do is try to comply a 100 per cent with your interpretation of the banking law and their directive to you as far as your interpretation goes.

THE COURT: I see.

[145] By MR. WATSON:

Q. Mr. Eccles, I show you a copy of what has been received in evidence as Petitioners' Exhibit 54 and ask you what that is, sir?

MR. BOOHER: I will object to any answer to the question. He is showing him a copy of Title 12 U.S.C.A. 92, which is a Federal Statute.

THE COURT: What does your stipulation say that Exhibit 54 is?

MR. WATSON: It has been received in evidence.

THE COURT: Yes, I know, but may I have a copy of the stipulation?

MR. BOOHER: I believe it was received in evidence to assist the Court.

THE COURT: I think it has already been stipulated that Exhibit 54 is Title 12 U.S.C.A. Section 92 and 93, relating to the power of national banks to sell insurance.

You can ask that question. It is not a leading question and it is already stipulated to and you can show him the document.

The objection is sustained with the exception of the way the Court stated it.

Now, Mr. Eccles, that is what that is?

THE WITNESS: I understand that's right.

By MR. WATSON:

[146] Q. Now, as a president of a national bank and associated with these various national banking associations, are you familiar with the provisions of these two sections?

A. I am.

That is my bible, you might say.

Q. Now, have you discussed these provisions with legal counsel?

A. I have.

Q. And have you also discussed these provisions with

various other officers and directors in the banking fraternity?

A. I have.

Q. Now, is it your understanding, based on such discussions and upon your knowledge and experience as a banker that it was illegal for banks to receive permissions or fees for services rendered in selling insurance in cities over 50,000 in population during the years 1954 through 1959?

MR. BOOHER: I object to that question as calling for legal opinion on the part of the witness.

If he bases his opinion on discussions with third parties who are not in court, it would be hearsay because the source of the information he has given is a statement or opinion of an individual which also is not present in the courtroom, not subject to cross-examination and we have no way of determining the validity or accuracy of research used in developing this opinion.

[147] THE COURT: I overrule the objection for the reason, as a businessman, he would take certain action, based on the advice given to him by his legal staff and the other individuals.

And this question, I assume, is directed to his business reactions to the advice and not to whether or not—not to the question of whether or not that advice was——

MR. BOOHER: If I understand the Court's ruling then, the relevancy of the answer to this question will be limited to the business purpose for this witness doing whatever he did.

It will not involve a correct or incorrect interpretation of Title 12 U.S.C.A. 92, no legal interpretation, correct?

MR. WATSON: No, just his understanding of what these provisions meant.

THE COURT: That's right.

THE WITNESS: Your Honor, I can enlarge on that a little bit from actual experience.

We acquired a state bank.

MR. BOOHER: I don't believe this answer is responsive to the question.

THE WITNESS: Well, I was going to report—what I was going to report was the examiner's——

THE COURT: Do you want it read back again?

THE WITNESS: I believe so.

[148] (Record read.)

THE WITNESS: My answer would be yes on that.

By MR. WATSON:

Q. Would a bank seek to have borrowers to take credit life insurance whether or not they received income of any sort from the insurance written?

MR. BOOHER: I object to the question as being too general and speculative.

THE COURT: Rephrase it and say, "Did a bank"? et cetera. You are saying, "would a bank", I believe.

Read the question back again, Mr. Reporter.

(Record read.)

THE COURT: If you change that would to did, do you remember the question now?

THE WITNESS: Yes.

MR. WATSON: Let me put it this way.

MR. BOOHER: I understand the witness has some papers there.

Are those notes?

THE WITNESS: I have papers, but I answer without them. I was trying to hurry things up.

THE COURT: You can refresh your recollection if you need figures.

I think he was doing that for the record to show that perhaps some of this was not coming off the top of his head.

[149] By MR. WATSON:

Q. Is there a benefit to the Petitioner banks to having credit life insurance, whether they receive any income as a result of the insurance being written on the lives of those borrowers?

MR. BOOHER: I object to the question.

Do you say is there a benefit with no income? The question is rather confusing to me. What is the purpose of this question?

MR. WATSON: I have in mind the Security.

THE COURT: The objection is overruled.

You may answer the question.

THE WITNESS: There is benefit.

It assists you in the credit goodness of your loan. If you are making a loan and a man has no other assets than his earning power or his salary and he should die before the

loan is repaid, a personal loan, and you got credit life protection on it, you take no loss and your loan is paid off.

By Mr. Watson:

Q. Thank you.

In the years 1959—or 1954 through 1959, were there any contrast between the First Security Company or the employees of that company and American National with respect to selling or handling life insurance or credit life insurance?

Mr. Booher: If I may, could I ask the reporter to [150] reread that question?

The Court: Read it back, please, Mr. Reporter.

(Record read.)

The Witness: Not to my knowledge. I think not.

Mr. Booher: If I may——

The Court: Written contracts, do you mean?

Mr. Watson: Yes.

The Court: Yes.

Mr. Booher: May I have a few minutes discussion?

The Court: Yes.

Off the record.

(Discussion off the record.)

The Court: Back on the record.

By Mr. Watson:

Q. Does the First Security Company hold any agent's license to sell life insurance?

A. No.

Q. Does the First Security Company license any personnel in that organization to sell life insurance?

A. No, they couldn't.

Q. Does the company have—does the First Security Company have any contact with the public with respect to selling life insurance?

A. No.

Mr. Watson: You may cross-examine.

[151] Cross-examination

By Mr. Booher:

Q. Mr. Eccles, I understand that the First Security Life Insurance Company is now owned by the First Security Investment Company?

A. That's right.

THE COURT: Let me hear that question again, Mr. Reporter. Please, read it back.

(Record read.)

THE COURT: All right.

By MR. BOOHER:

Q. Is there any prohibition at the present time under the provisions of the bank holding company Act which would prevent First Security Life Insurance Company of Texas from becoming a full-line security company?

MR. ALLEN: That calls for a conclusion, your Honor. We object.

THE COURT: Well, I am going to let him answer that question.

THE WITNESS: First Security Investment Company is not a bank holding company. It doesn't come under the bank holding company Act at all.

They own it.

MR. BOOHER: The answer is not responsive to my question.

[152] I request the reporter to reread the question.

THE WITNESS: Yes, May I have the question again?

THE COURT: Reread it, Mr. Reporter.

(Record read.)

THE WITNESS: No.

THE COURT: For the reasons——

THE WITNESS: There are provisions in the bank holding company Act, your Honor, that would prevent it, but you couldn't organize one in the bank holding company. You couldn't do that.

By MR. BOOHER:

Q. The same would also be true from the year 1959 through the present time since the First Security Life Insurance Company of Texas has been owned by the First Security Investment Company since 1959?

A. In my opinion, yes.

Q. So, since 1959 through the present time, there has been no feature of the bank holding company Act which would have prevented the First Security Life Insurance Company from becoming a full line life insurance company?

A. No, because there is no relationship.

Q. Now, First Security Company—did First Security Company request a ruling with respect to whether the bank holding company could retain ownership of the First Security Life Insurance Company of Texas pursuant to the provisions of the bank company holding Act?

[153] A. Did they?

Q. Yes?

A. No, they didn't.

Q. They have not requested any such ruling?

Mr. Watson: He refers to the company and there might be some confusion.

The Court: Just a moment.

Come on, gentlemen. Let one party speak at a time.

If you don't, my record is going to be so confused that you won't understand it, and I won't understand it, so if there is an objection, allow counsel to finish it and by the same token, allow opposing counsel to get his words in singly or separately now.

Where do we stand? Who is doing what?

Mr. Watson: I am sorry, your Honor.

All I was trying to do was clear up the confusion between the company and the corporation and I probably was out of order.

The Court: No, you were not. You were within your —you are perfectly in order and there may have been confusion there, because I can see how this is confusing as I have been following it.

And everytime you say company or corporation, I have my notes here and I take note of the differentiation and it is difficult because they both have the same names.

[154] Are you sure you had your designations correct?

Mr. Booher: I asked the reporter to reread the last question.

The Court: All right, reread it, Mr. Reporter.

(Record read.)

The Witness: The answer is no.

The Court: Proceed.

By Mr. Booher:

Q. I understand the question was answered no, is that correct?

A. That's right.

THE COURT: Off the record.
(Discussion off the record.)
THE COURT: Back on the record.

By MR. BOOHER:

Q. I believe you testified that the banks would receive a benefit from the sales of credit insurance even if it received no income from this type of activity.

In fact, however, the banks did receive a commission from the sales of credit insurance or the management company received such a commission on sales of credit insurance through the banks prior to 1954?

MR. ANDERSON: I object to that question.

This record shows that the banks never took in one penny of commission or any other form of return from the sale [155] of credit life insurance at any time in the history of this banking organization.

THE COURT: Yes, but Mr. Eccles is very competent and a very capable witness.

MR. ANDERSON: But Mr. Booher assumed in his question that the banks had taken in the commission so the question is improper.

THE COURT: Let me have Mr. Eccles' answer, I think he knows more about this banking business than anybody else in the courtroom and even more than I.

THE WITNESS: The answer is we never took commissions.

THE COURT: Proceed.

I think you have to recognize, gentlemen, I am not controlled by the question at all. I don't pay any attention to it.

I look to the answer and any inference in the question is not going to be taken into consideration in any opinion that I write in this case.

By MR. BOOHER:

Q. I understand that our stipulation is to the effect that before 1954 the First Security Management Company reported a commission on the sales of credit insurance to customers of Petitioner banks.

I didn't understand that last——

MR. ALLEN: There isn't a question there, your [156] Honor.

The Court: He hasn't asked a question yet.

By Mr. Booher:

Q. But that is a stipulation that commissions were paid on sales of credit insurance through Petitioner banks prior to 1954 and that commission was reported in taxable income by the First Security Management Company?

Mr. Allen: Let's have him read the stipulation if we are going to preface the question——

Mr. Anderson: The stipulation states that. We stipulate to it. The stipulation says that First Security Management Company during the years '48 to '52 reported commissions that were paid under an insurance agency agreement with Ed D. Smith and Company, executed by Credit Life of Springfield and American Life of Florida.

The management company did take the commission and that is what the stipulation states and we will rest on that.

The Court: Let me say something, gentlemen.

It is going to be too confusing if I find three lawyers on Petitioners' side of the room, one making objections and one asking questions on direct examination and someone else making statements.

I think you had better get together and nudge one another, but let me have one lawyer from the Petitioners' side make the objections.

[157] You can nudge Mr. Watson and I will give you plenty of time to discuss any objection. I would prefer to have one man making the objections as it is too confusing otherwise.

Go ahead, Mr. Booher. You understand now what the agreement is regarding the stipulation and I think the witness knows, too.

Do you have a question?

By Mr. Booher:

Q. With respect to sales of credit insurance before 1954 to customers of Petitioner banks, Petitioner Management Company did in fact receive a commission on such sales; is that your understanding?

A. I don't think it was a commission. I think it was a reimbursement of expenses, a certain reimbursement.

They were not an insurance agency and they couldn't receive a commission.

They had no agency. They could be reimbursed and that is all, for expenses.

MR. BOOHER: If I may, your Honor, I would refer back to the stipulation which is that the management company——

THE COURT: The stipulation under our rules is controlling, as you know.

So, I don't think you need say anything further. You know what the rules provide.

By MR. BOOHER:

[158] Q. Is it your understanding, Mr. Eccles, that the management company and the banks have never received a commission on the sales of credit insurance before as well as after 1954?

A. A commission, no.

Q. Now, we have stipulated into evidence the income tax returns of Petitioner Management Company for the years 1955 through 1959 as Exhibit C-3.

I can furnish you these returns to look at it if you desire, but my question is, did Petitioner, management company report income from commissions on the sales of insurance during the years 1954 through 1959?

A. I have never seen the returns. I didn't make them.

Q. I would take it your answer is you have no personal knowledge as to whether they did or not?

A. I have no knowledge of it.

Q. Would your answer be that you have no personal knowledge as to whether they reported a commission from the sale of insurance before 1954 also?

A. I haven't been over the income tax returns.

Q. Well, do you presently have any knowledge as to whether they did report a commission prior to 1954?

A. I have no present knowledge of it, no.

THE COURT: You have no present knowledge?

THE WITNESS: No. Expenses, I think, but not [159] commission.

THE COURT: All right.

You mean reimbursement of expenses?

THE WITNESS: That's right, your Honor, yes.

THE COURT: Mr. Booher, if your examination is drawing to a close, I will take a five-minute recess if it will facilitate things.

Are you getting near the conclusion of it or——

MR. BOOHER: I would appreciate a five-minute recess and I can finish this up within a few minutes after the recess.

THE COURT: Very well.

We will recess for five minutes, then.

(Short recess.)

THE COURT: Back on the record.

Proceed, Mr. Booher.

By MR. BOOHER:

Q. As I understand your testimony, the First Security Life Insurance Company of Texas is not today a multiple line or full line life insurance company; is that correct?

A. That's correct.

Q. Now, in discussing the expansion of the subsidiary corporations owned by the two holding companies, I don't believe you discussed a foreign corporation known as F.R.G. Company, a Lichtenstein Corporation, right?

[160] MR. WATSON: We are going to object to this, your Honor, because anything on the Lichtenstein Corporation has been excluded from the record as being prejudicial.

THE COURT: Did I admit that?

MR. WATSON: You excluded all of that yesterday.

THE COURT: The objection is sustained.

MR. BOOHER: The evidence was offered at that time on the issue of tax avoidance or tax motivation and since that time the witness has testified to the reasons why the First Security Life Insurance Company of Texas did not develop into a multiple line life insurance company.

We believe that the testimony concerning the first F.R.G. Corporation will be relevant as explaining as why this corporation has so developed, that is, the Texas life insurance company, since much of the income from the sales of credit insurance was diverted from the First Security Life Insurance Company of Texas into the foreign corporation.

This evidence is also relevant with respect to Petitioners' business purpose for using the First Security Life Insurance Company of Texas since they state that they formed this company as an investment company to generate income from investments.

The activity of Petitioners in diverting income from the First Security Life Insurance Company of Texas into the First R.G. Corporation would be inconsistent with the opinion.

[161] On these points we believe that testimony concerning the F.R.G. Corporation is relevant to the issues in this case.

MR. WATSON: I don't see where if could at all be relevant to the business reasons for organizing a First Security Life Insurance Company back in 1954 to what happens in 1959 or 1960 pertaining to the foreign corporation.

And it certainly doesn't have anything to do with whether the First Security Life Insurance Company could become a full direct writing life insurance company.

It is another thing done many years later and for different purposes.

THE COURT: I am going to permit the witness to answer.

You may answer.

MR. BOOHER: I request the reporter to read the last question back.

(Record read.)

MR. WATSON: May I make one further objection?

MR. BOOHER: There is no objection to the question as actually being asked. There is no basis for an objection at this point.

THE COURT: Yes.

By MR. BOOHER:

Q. When was the First R.G. Corporation formed?

MR. WATSON: I am going to object to that. This [162] corporation has nothing to do with the issues involved in this case. It isn't related to any of these Petitioners that are before the Court.

And it is—it functions years that were subsequent to the years that are in issue.

THE COURT: The objection is overruled.

You may answer the question.

MR. BOOHER: If I may——

THE WITNESS: I am not sure of the date.

By MR. BOOHER:

Q. If I said that it was formed in the latter part of 1959, would that be substantially correct?

A. Yes. I can answer yes to that.

Q. Was the business of the First R.G. Corporation primarily the reinsurance of credit insurance sold to borrowers of Petitioner banks?

A. Together with automobile casualty insurance.

Q. It dealt with other types of insurance also?

A. Automobile casualty, yes.

Q. What advantages did the First R. G. Corporation have over the First Security Life Insurance Company of Texas?

A. It could write auto casualty. It was a foreign corporation and it could invest in foreign securities.

Q. However, the premiums paid into the First R. G. Corporation with respect to credit life, health and accident [163] insurance could equally as well have been paid into First Security Life Insurance Company of Texas?

Mr. Watson: I object to that as being argumentative and outside the issues in this case.

The Court: Overruled.

You may answer.

The Witness: They could have been, but they couldn't have been used for foreign investments which was our purpose at that time because of the foreign money market and the domestic money market.

We were able to invest in Barkeley Bank of London at six and six and a half per cent while the rate in this country was three per cent.

Every dollar in reinsurance in the reinsurance company was invested in foreign investment and because of my knowledge in the foreign field, working in the World Bank and in the Marshall Plan.

Mr. Booher: Could you please reread the question, Mr. Reporter?

The Court: Yes—no. You may finish, Mr. Witness.

The Witness: We felt that the foreign market was very desirable in relationship to the rate of interest that we could get on securities domestically.

For several years the foreign money such as the English pound, the German mark, the Italian lira, the Belgium franc and others were sound.

[164] There wasn't a question of the valuation at that time. We even put our money in without hedging the foreign exchange at all. We did it to increase the incomes you could get by making foreign investments.

By Mr. Booher:

Q. And was the First R.G. Corporation liquidated?

A. It was.

Q. When was it liquidated?

Was it approximately in 1963?

A. It was liquidated when the pound sterling became very weak.

It was talked of devaluation. All your foreign currency became very weak in relation to the dollar and just the investment field wasn't conducive in the foreign after that time—or about that time.

Q. And at the time of its liquidation, the F.R.G. Corporation paid a liquidating dividend to its parent corporation——

MR. WATSON: We object to this, your Honor. It is going way outside the issues in this case.

It has nothing to do with what we are dealing in.

THE COURT: Yes. We have gone far enough into this, Mr. Booher.

By MR. BOOHER:

Q. Now, according to your testimony, or your understanding [165] of the Title 12 U.S.C.A. Section 92, receipt of a commission was illegal.

If so, why as a businessman could you not provide a cheaper insurance for your customers or have the banks rebate their over changes to your customers?

A. We charge the rate which is permitted by state law. We charge the rate that was charged by our competitive finance companies and our customer finance companies. There was no reason to go ahead and give a lower rate.

Q. Well——

THE COURT: Let him finish his answer.

THE WITNESS: That is all I have.

By MR. BOOHER:

Q. In charging the prevailing rate at least for the years before 1954, did not that prevailing rate usually include the payment of a commission or a retrospective rebate to the lending entity or an affiliated entity?

MR. WATSON: I want to object to this question.

He is asking the witness about questions that require an intimate knowledge of the insurance business and how they operate, how they figure their commissions, what sort

of actuarial data they base their figures on, I don't think it is proper.

THE COURT: Well, Mr. Eccles will be able to handle the question.

[166] You may answer, sir.

THE WITNESS: May I have it repeated?

THE COURT: Yes.

Please read it back, Mr. Reporter.

MR. WATSON: Another thing, or another point that I think that we ought to object to is that it doesn't say payment to who? There is nobody designated as the recipients.

MR. BOOHER: I withdraw the question.

THE COURT: All right.

I was having trouble understanding the ramifications of it, too.

By MR. BOOHER:

Q. I understand your testimony is that Petitioner banks charged the prevailing rate with respect to credit insurance sold to bank customers sold before 1954?

A. I think they did. To my knowledge they did.

Q. Did not the prevailing rate charged on credit insurance before 1954 make allowance for the payment of a commission or a retrospective rebate to the lender or a related entity?

MR. WATSON: I hate to keep interrupting, but I think once again this is a question for an insurance man.

THE COURT: Well, I have ruled on that.

You may answer, sir.

THE WITNESS: The prevailing rate was set by the [167] State Insurance Commissioner.

I don't know how he set the rate.

By MR. BOOHER:

Q. Did the First Security Management Company report in its taxable income commissions on the sale of credit insurance for the years before 1954?

THE COURT: I think that has been answered—or that has been asked before.

MR. BOOHER: It has been answered and it has been stipulated also.

By Mr. Booher:

Q. The answer is yes?

A. My answer wasn't yes.

The Court: The record will show what the answer was. That question was asked and there was an answer previous to our recess.

Now, whatever the record shows the answer was, that is what the answer is.

By Mr. Booher:

Q. Did the First Security Banks charge the prevailing rate on sales of credit insurance to their customers before 1954?

Mr. Watson: Your Honor, the banks don't charge the rate.

[168] That is the insurance company.

The Court: I am aware of that. I mean the way the question is framed is not going to confuse me.

Has your answer right along been whatever they were told to charge, they charged?

The Witness: The bank acted as agent for the borrower and they collected the rate that was specified in the rate schedule and they acted as an agent to remit that to the insurance company to cover the cost of the insurance.

The Court: I am aware of the factual background, yes.

Mr. Booher: I have no further questions.

The Court: Any redirect?

Mr. Watson: No redirect, your Honor.

The Court: Thank you, sir, you are excused.

(Witness excused.)

The Court: Call your next witness, please, sir.

Mr. Anderson: I call Tom Hawkes.

Thomas F. Hawkes

was called as a witness on behalf of the Petitioners, and, having been first duly sworn, testified as follows:

The Clerk: Take the witness stand, sir, and for the record, may we have your name?

The Witness: Thomas F. Hawkes, H-a-w-k-e-s.

The Clerk: And your address, sir?

[169] The Witness: 1149 Bonneville, B-o-n-n-e-v-i-l-l-e, Drive, Salt Lake City, Utah.

Direct examination

By Mr. Anderson:

Q. What is your business, Mr. Hawkes?

A. Vice-president and treasurer of the First Security Corporation.

Q. How long, please?

A. I had the title of vice-president since 1950, prior to that time having the title of comptroller.

Q. To clear up what has gone on previously by——

Mr. Anderson: Strike that.

By Mr. Anderson:

Q. To clear up what has gone on previously about commissions from 1948 to 1952, the stipulation has been read into evidence and it was that from '48 to '52 there were agency agreements with Ed D. Smith & Sons outstanding with Credit Life of Springfield and American Bankers Life of Florida whereby there would be a commission paid to Ed D. Smith & Sons for the sale of Credit Life Insurance by the banks.

Now, during this period of time, was this income under the—that is the income to go to Ed D. Smith & Sons taken into income by the First Security Company?

A. Yes.

Q. And reported on their tax returns?

[170] A. Yes.

Q. Was there any special reason for that?

A. Well, the banks at that time were just getting into the installment credit field in a big way.

Prior to that it was very small. As we entered into that field we got into this credit life program.

To start out with, it was very small. And this arrangement was entered into by our subsidiary Ed D. Smith & Sons.

Checks were issued by these insurance companies to Ed D. Smith & Sons for these commissions. For some reason, I can't tell you why, for no better place to put it, it went through the books of First Security Company.

Q. Was that a constitution made by management?

A. No. It seemed to happen because of the smallness of the amounts. It was deemed of no consequence at the time.

As it became larger, then at that time it did come before management.

Q. Was that about the time that Security of—Security Life of Texas was formed?

A. Yes.

Q. And the problem was then eliminated?

A. Yes.

MR. BOOHER: I object to the line of questions as being leading.

[171] MR. ANDERSON: This line is through.

THE COURT: The answer will stand.

By MR. ANDERSON:

Q. From 1954 through 1959 Mr. Booher asked on his examination of Mr. Eccles whether an item——

MR. BOOHER: I object to that as a leading question in the examination of a different witness.

THE COURT: Overruled.

This is preliminary to another question.

By MR. ANDERSON:

Q. —stated that an item appeared on the tax returns of the First Security Company referring to insurance commissions.

I show you Exhibit C-3, the tax returns of the First Security Company and an item on one of those returns.

Would you please read the item?

A. The top one?

Q. This item.

A. "Commissions insurance gross."

Q. Were those commissions—what were those commissions—what does that refer to?

A. Well——

Q. Does this refer to——

A. It is an item of income reported. Definitely, it is not a commission. It applies only to automobile casualty insurance.

[172] Q. Does it have anything to do with the insurance involved in this suit, credit life insurance?

A. No.

Q. Is the word "commission" in there appropriate?

A. No, definitely not. It is not a commission.

Q. Explain to the judge, so that this record will be clear, just how management company from 1954 through 1959 was handling automobile casualty insurance, and why this item of income would appear on these tax returns.

A. Well, during this period, banks were getting into the automobile finance deal. It was new. It was very difficult to obtain insurance on the automobiles financed. In fact, we couldn't get it. So we had to go—on I believe they call it a retrospective plan in which we absorbed the loss.

If for some reason or other it did show in the black, there was a refund made, and that is what this particular item was, pertaining only to automobile casualty insurance.

Q. Was that a profit function for the company?

A. No. Over the years it has been a loss.

Q. Was it meant to be a profit function for the company?

A. No.

Q. What was it meant to be?

A. It is just a method of obtaining insurance. We couldn't have claimed it in any other way.

[173] Q. Would it refresh your recollection if I stated that it was to cover expenses that the company incurred?

Mr. Booher: I object to that as a leading question.

The Court: I sustain the objection. It is leading.

By Mr. Anderson:

Q. Did the company incur any expense in writing any automobile casualty insurance during these years from 1954 through 1959, the management company?

A. There were some expenses incurred in the writing of that insurance, yes.

Q. Did the retrospective rebate have any relationship or bearing—any relationship to these expenses?

A. No. It could have gone either way. This particular year it evidently produced a return. However, there were other years where it was in the red more or less.

Q. Has the company made an overall profit from handling automobile casualty insurance?

A. I would say no.

Q. Was the word commission on those taxable returns a conscious decision by management? Do you know how it got there?

A. Well, "commission" is not the right word. I think it

is probably just following the tax form, isn't it? It definitely isn't a commission. It is an experience factor [174] there that was paid back to the company.

Mr. Anderson: You may cross-examine.

Cross-examination

By Mr. Booher:

Q. If I understand your testimony, this automobile insurance is insurance taken out on automobiles financed by the bank?

A. Yes.

Q. And the premium was paid by the purchaser of the automobile?

A. Right.

Q. And at the end of the period there would be a determination as to whether that premium was excessive or perhaps insufficient?

A. I suppose that is it. What is the right term, retrospective? Is that the word?

Q. Well, in the event that it were determined or found that the premium paid by the customer was excessive, would that excess be refunded to the customer?

A. No.

Q. That excess would be returned—or retained by the First Security Company?

A. Right.

Mr. Booher: I have no further questions, Your Honor.

The Court: Any redirect?

[175] Mr. Anderson: May we have a moment?

The Court: Yes.

Mr. Anderson: That is all we have.

Thank you, Mr. Hawkes.

The Court: You may step down, Mr. Hawkes. You are excused.

(Witness excused.)

Mr. Watson: Could we have a minute or two?

The Court: Let the record show that yesterday when you were introducing a number of exhibits the Court excluded some and admitted others, and this is going to affect your stipulation of facts, your supplemental stipulation of facts, and I am not sure whether it is on the record or not,

and I want it on the record that what you are going to do is submit another exhibit to the Court which will reflect the number of exhibits which were admitted and the number of exhibits which were excluded.

Is that right?

Mr. Booher: That is correct, Your Honor.

The Court: Is that your understanding, too, counsel for Petitioners?

Mr. Anderson: The exhibit that we are going to talk about now has been previously marked——

The Court: I don't want to get into anything we are talking about now.

[176] Yesterday at the start of the trial, the Court ruled out several exhibits and it admitted several others, the ones that you objected to for materiality and relevancy having been excluded, and all of this.

Now, since you have a stipulation of facts before the Court listing those exhibits which you thought would be admitted into evidence, which were not admitted, to that stipulation of facts I want another exhibit attached or some statement attached regarding the exhibits which are in evidence, and those which were excluded.

Mr. Anderson: Very well. We will prepare such a list and submit it.

The Court: The minutes of the Court will have to show this, and I realize that we are getting outside of our normal routine by virtue of the manner which we proceeded, and this will take care of that.

Mr. Anderson: We will prepare such a list, and submit it to the Clerk, Your Honor.

The Court: All right. Proceed.

Mr. Watson: Your Honor, as you will recall in some of the pretrial conferences, we made an arrangement to put on a time and cost study prepared by Mr. Hermansen. We would like to call Mr. Hermansen for that purpose.

The Court: All right.

Mr. Watson: Also, in accordance with the agreement [177] reached at the pretrial conference, we said we would make a very brief explanation in order to save time. This was a study made at our request by Mr. Hermansen to determine the actual cost to the Petitioner banks and to the Petitioner companies for processing, handling the insurance certificates, collecting the money, transmitting them from

the banks to the Petitioner companies, and from the company down to American National.

Now, with that preliminary explanation, we are offering Exhibit—Petitioner's Exhibit 57 for identification and having Mr. Hermansen take the stand for the purpose of cross-examination by the Respondent.

The Court: Very well. He may be sworn.

Phil J. Hermansen

was called as a witness on behalf of the Petitioners and, having been first duly sworn, testified as follows:

The Clerk: Take the witness stand, sir, and may we have your name, please?

The Witness: Phil J. Hermansen.

The Clerk: What is your address?

The Witness: 1622-25th Street, Ogden, Utah.

Cross-examination

By Mr. Booher:

Q. Am I correct in your understanding that the general procedure for handling credit insurance during the years 1954 [178] through 1959, which are reflected in your study, are substantially as follows, that when a loan officer in the installment loan or commercial loan department of the First Security Banks interviewed an application for loan, they briefly explain to the borrower that insurance was available to assist them to pay off the loan that they had if the borrower died?

A. Yes.

Q. Then the loan officer would give the borrower an application form; is that correct?

A. That is my understanding, yes.

Q. And the application form would be filled in by personnel of Petitioner banks?

A. No. The application form would be filled in by the borrower.

Q. Then what forms were filled in by personnel of Petitioner banks?

A. The certificate or the application for certificate.

Q. And on completion of the certificate or application for certificate, as you call it, the document will be executed by the borrower?

A. In some cases it didn't require an execution. It was a group policy.

Q. At the time these forms were completed, was the full amount of the premium collected from the borrower?

[179] A. Yes, or added to the loan.

Q. And thereafter the amount of the premium, together with the completed forms, was transmitted to the Petitioner, First Security Management Company?

A. Correct.

Q. And then First Security Management Company transmitted the completed forms and the premium to the American National Insurance Company?

A. That is right.

Q. Now, this study that you have made, was this study made recently in connection with this case?

A. Yes.

Q. This study was not made contemporaneously with the years involved?

A. No.

Q. This study was not made for management purposes during these years?

A. No.

Q. This study was made for purposes of this litigation?

A. Yes.

MR. BOOHER: I have no further questions.

THE COURT: Any redirect?

MR. WATSON: There is just one thing we want to look at in the exhibit, Your Honor, and we will offer it into evidence.

[180] THE COURT: Is there another copy?

MR. WATSON: We have no redirect, Your Honor, and we are at this time offering the exhibit into evidence.

MR. BOOHER: No objection, Your Honor.

THE COURT: All right. Now, gentlemen, it is agreed that this witness is qualified, and all that, to proceed with this? There is no objection to that part of it?

MR. BOOHER: My understanding is that this is not a type of study which requires special qualifications. It is a mathematical computation.

MR. ANDERSON: May I speak?

THE COURT: Yes.

MR. ANDERSON: The study does require intimate business knowledge of Mr. Hermansen with the operations of the

company, not just any Tom, Dick or Harry, to go around and interview the people.

He spent many weeks traveling around to branches and talking to the people involved. He is especially qualified.

The Court: I meant a cover sheet showing his qualifications on what he had done.

Mr. Anderson: If that would help the Court, we will ask him those questions, unless Mr. Booher will stipulate to his answering and qualifications as an officer in the business.

[181] The Court: Mr. Booher?

Mr. Booher: I think——

The Court: Well, I think we had better put on the record his qualifications.

Redirect examination

By Mr. Watson:

Q. Mr. Hermansen, what offices do you hold with the First Security Company?

A. I am assistant secretary and assistant treasurer.

Q. How long have you held those offices?

A. Over 25 years.

Q. And have you been with the First Security Company for 25 years?

A. Thirty-one years, sir.

Q. As the assistant secretary and assistant treasurer, what is the nature of your duties?

A. Presently preparation in the supervision of the—supervision in the preparation of our tax returns, supervision in personnel operations in our immediate office, and the management company, I should say.

In the past I have also been in charge of our complete personnel operations, so I am thoroughly familiar with the various job classifications and positions and what these people do in each of our offices.

Q. And in connection with your employment you have had [182] ample opportunity to become familiar with the manner in which these insurances are processed; is that correct?

A. That is correct.

Q. Would you explain to the Court the procedure you followed in making the study that we presented as Exhibit 57?

A. Yes. Through interviews with the various people in-

volved, I determined the procedures at the office level for both the management function and the clerical function.

I also determined the procedures at the management company level.

I sent these procedures out in written form, which is included in the exhibit, and through interviews with the people actually doing these jobs, some of these in person, some by telephone, verified by letter from them later, I determined the average length of time for each of the procedures.

We then determined from records available the number of policies written, the number of refunds made, the number of claims paid, so we had a complete total for each procedure.

And multiplying these out, we arrived at a total number of hours for the operation.

I then went back to our personnel records and from actual records I determined the number of weeks paid to each of the people involved in these procedures.

[183] The actual weekly salary by week, and multiplying this out, multiplying each rate by the number of weeks that rate was paid, and dividing by the total number of weeks, I arrived at the average weekly salary.

I then determined—it is commonly known as fringe benefits, although it is probably a misnomer—the benefits applicable to the salaries, by taking the total benefits—may I refer to my notes here?

The Court: Yes.

The Witness: These benefit costs included Social Security, Federal and State Unemployment, Workmen's compensation, group insurance, retirement contributions, bonus and vacation costs.

When I obtained the dollar figure for these for each company involved, by dividing this dollar figure by the total salaries paid, I determined the fringe benefit cost per salary dollar, and by multiplying the average weekly salary by this factor I determined the fringe benefit for each salary, thus arriving at an average cost per week.

Our average work week is 40 hours. Dividing this average cost by the 40 hours, I arrived at an hourly rate.

I developed this procedure both for the executive level and the clerical level.

And then multiplying the total number of hours by

the average salary obtained, I obtained a cost figure, the [184] total cost figure.

I then determined the weight of the policies of the cancellations claimed, to determine a postage cost. An allowance was included in this to cover cost of transmittal documents, tapes, and other things.

Adding this cost to the salary and benefit cost, I arrived at a total cost, following the procedures set out.

Mr. Anderson: We have nothing further, Your Honor, if that satisfies the Court.

The Court: And have you made, not similar studies, but have you done work of this nature before for the company?

The Witness: I have made some special studies, yes, in various departments.

The Court: That is what I meant.

The Witness: To determine the cost of the department.

The Court: And did you have clerical help and other perhaps professional help, if you care to call it that, in preparation for this report?

The Witness: I consulted with members of our CPA firm as to whether my procedures would adequately give a true cost, and they——

The Court: They approved of your procedure for this computation?

The Witness: Yes.

[185] The Court: All right.

I assume that concluded your direct, did it? Or your redirect?

Mr. Anderson: It did.

The Court: And there is no recross?

Mr. Booher: No.

The Court: Thank you very much, sir, you may step down.

And Exhibit 57 is received.

(Witness excused.)

(The document previously marked for identification Petitioners' Exhibit No. 57, was received in evidence.)

Mr. Anderson: Your Honor, may we take a moment to set this screen up?

The Court: Yes. We are going to recess at five minutes to 12:00. I am due at a luncheon at 12:15.

Mr. Anderson: I suggest that I take this time now before the lunch hour to put up the screen and spend the next ten minutes qualifying the next witness so that after lunch we can get started.

Is that satisfactory?

The Court: All right.

Mr. Anderson: I call Mr. Arthur Crooks Eddy.

[186] Arthur Crooks Eddy

was called as a witness on behalf of the Petitioners and, having been first duly sworn, testified as follows:

The Clerk: For the record, may we have your name?

The Witness: Arthur Crooks Eddy.

The Clerk: How do you spell your middle name?

The Witness: Just like it sounds, C-r-o-o-k-s.

The Clerk: How do you spell your last name?

The Witness: E-d-d-y.

The Clerk: And your address, please?

The Witness: 2456 Hanover West Terrace, Atlanta, Georgia.

Direct examination

By Mr. Anderson:

Q. What is your business, Mr. Eddy?

A. Consulting actuary.

Q. With what firm?

A. With the firm of Bowles, Andrews & Towne.

Q. How large is that firm?

A. The number of employees do you mean?

Q. How large geographically, and the number of employees.

A. Geographically, we have offices spread up and down the East Coast, one at Atlanta, one at Richmond, and one in New York, and one in Portland, Maine.

We have approximately 100 employees in the firm.

[187] Q. Are you in the Atlanta office?

A. Yes.

Q. How many employees are there in the Atlanta office?

A. Approximately 60.

Q. What is your position in the Atlanta office, and with the company?

A. I am managing partner in Atlanta, and with the firm

I am deputy managing partner.

Q. When did you begin your actuarial career?

A. 1948.

Q. Where?

A. Pilot Life Insurance Company, a subsidiary with the Jefferson Standard in Greensboro, North Carolina.

Q. How large is that company?

A. As of the current date, the combined company is about tenth in size, based on assets, tenth amongst the stock companies in the United States.

Q. When did you leave the company and what position did you hold?

A. I left the company, Pilot Life Insurance Company, in August of 1962, and at that time I held the position of second vice-president——

Q. Are you a fellow of the Society of Actuaries?

A. Yes.

Q. What year did you become admitted as a fellow?

[188] A. In 1955.

Q. What did your duties at Pilot Life Insurance Company include, please?

A. The general scope of actuarial work that is required by the home office personnel of a life insurance company.

Q. When did you join Bowles, Andrews & Towne, your present firm?

A. As of August 1962.

Q. In what position?

A. I joined the firm as partner in charge of the Atlanta office.

Q. Then became, as you said, deputy managing partner of the firm?

A. Yes.

Q. Have you held any positions with the Life Office Management Association?

A. Yes, sir, I have. I have been on the Educational Council.

Q. Are you a member of the Academy of Actuaries?

A. Yes.

Q. Are you fully accredited as an actuary?

A. Yes.

Q. Are you familiar with the credit life insurance business, Mr. Eddy?

A. Yes.

[189] Q. Explain to the Judge how you are familiar with that industry.

A. It began with my experience at Pilot.

In the mid-Fifties, Pilot was very active in the credit insurance business, and this became a very substantial part of their group operation during that period of time, and it was necessary in the duties of the actuarial department to assist in matters relating to the credit insurance business of the company, and this was the total scope of operations, and it included various facets of credit life.

Q. What has been your contact with the credit life business since that time?

A. Our firm are consultants for a number of credit life insurance companies, or companies writing credit life insurance.

Q. Can you express to the Court the percentage of credit life in force through your firm in relation to what is in force in the United States?

A. Amongst our clients, the total is ten percent, or in excess of $6 billion a year.

Q. Is that considered large, small or medium?

A. A volume of $6 billion out of approximately $60 billion.

Q. Do you consider yourself familiar with the industry?

A. Yes.

[190] Q. During the years 1954 through 1959, what was the standard premium rate for decreasing term credit life insurance?

A. Single premium decreasing term, one dollar per hundred.

Q. Level term would be what?

A. Two dollars per hundred.

Q. In evidence in this case are group credit life policies by American National, issued on lives of debtors of First Security Banks of Utah and Idaho. Those policies state a figure of one dollar and 54 cents.

Would you explain to the Court whether that constitutes any variation in rates from the one dollar a hundred in rate you just quoted?

A. Only in that this $1.54 was derived from an average of the premium rates demonstrated in the table within the contract.

Those premium rates varied by age and issue, and in the aggregate were assumed to be $1.54 on an average, and this

is per thousand, and this translates to precisely one dollar single premium per $100.

Q. The banks were charging the going rate during the years in suit?

A. Yes.

Q. The Government had admitted into evidence Exhibit [191] C-J which you have previously examined, which contains formulas for various rates.

Are these formulas in any way inconsistent with what you have just testified to?

A. Not in my opinion.

Q. Are you familiar with the First Security Life Insurance Company of Texas?

A. Yes, sir.

Q. At our request have you examined its operations?

A. Tell the Court why a company would begin by reinsuring only.

A. Well, the major purpose for commencing a life insurance company operation through reinsurance would be a reduction in initial capital requirements.

For instance, to start a life insurance company it is necessary to have a considerable amount of capital, too, for tool-up expense, for organizational expenses, for developing such things as premium rates, policy forms, mechanical forms for data processing.

These could be obtained generally as a reinsurer by employing someone else's forms.

Q. Is there any comparison between a life insurance company, such as Security Life of Texas, and the life insurance agents?

[192] A. No, sir. Businesswise they are different concepts.

Q. Explain to the Court just how different those concepts are.

A. As an agency organization, an entity would be concerned with simply selling an intangible product, and its sole interest in this product would be in the commissions or the compensation received for its efforts in the sale.

A life insurance company, on the other hand, is in the business of assuming risks, and is in the business of dealing with probabilities, a substantially different principle.

Q. Describe the differences, if any, between a reinsurance company and a direct line insurance company, the fundamental difference.

A. With respect to the risk assumptions, there are no differences. The fundamentals are the same.

The modes of operation are different, of course.

Q. As a consulting actuary, do you consult on rates and rate structures with companies in the credit life insurance industry?

A. Yes, sir, we do.

Q. Are you familiar with rates, mortality experience, and other elements in the credit life insurance industry?

A. Yes, sir.

Q. When you are determining rates and other data, do [193] you tailor your recommendations to the individual company or not?

A. Generally speaking, in the life insurance business, including the credit life insurance, it is a matter of tailoring the company's operation to life within a given rate which is generally the competitive rate or going rate.

Q. Are all credit life insurance companies the same in their rate needs, in their finance needs, and in their actuarial needs?

A. No two companies would be the same with respect to these particular points.

Q. Would there be a difference between a small company as compared to a large company?

A. Of course, a considerable difference with respect to the points that you mention.

There would be a considerable difference in requirements as to the distribution of the premium dollar.

Q. Briefly explain that to the Court.

A. Well, the premium that you collect from the insurer is comprised of several elements. I do have a chart that perhaps might be more easily followed than my conversation, but essentially, for Company A, the ingredients of its premium totaling, let's say, a dollar, since we are speaking in terms of credit insurance, a certain percentage for claims and other premiums available for expenses, and other expenses available [194] for profit.

Another company might have a different distribution of its premium dollar, and if charging the dollar premium, as with the first company, would have a different percentage on each of those.

Q. Based on your actuarial experience, is there any absolute factor set aside that—set aside in each premium dollar for commissions or other similar elements?

Mr. Booher: I object to that question as leading. It can be answered yes or no.

It is argumentative and leading.

The Court: I will let the witness answer the question. The objection is overruled.

The Witness: Well, there is no absolute certainty when dealing with probabilities.

There is always a chance fluctuation that something will occur outside the realm of averages. This is particularly true in cases of smallness. The actuaries rely quite heavily on average premium rate. They take that into consideration in deciding whether a particular company can live within a competitive premium or going rate on the market.

It isn't sufficient, however, to rely on averages. My favorite illustration is that you might easily drown wading across the creek which is on the average six inches in depth.

As to small life insurance companies, in that [195] respect you must guard against two things, one being fluctuations due to small numbers, and another being due to catastrophic currencies.

By Mr. Anderson:

Q. On your examination of the report of the First Life Security Company of Texas, have you considered all the elements which you have just described to this Court?

A. To the best of my ability.

Q. Based on this study and your experience, have you formed an opinion as to how much of the money received by First Life Security Company between the years 1954 and 1959 should be retained by that company to keep it on an actuarially sound basis?

The Court: Answer yes or no.

By Mr. Anderson:

Q. What is that opinion?

Mr. Anderson: I can get a very brief answer from him here, and then I suggest we then recess, and we explain it after lunch.

By Mr. Anderson:

Q. What is your opinion?

A. The size and nature of the risk assumed by this com-

pany in relationship to its capital structure required it to retain every dollar that it could possibly do so.

Q. To stay on an actuarially sound basis?

[196] A. Yes.

Mr. Anderson: Very well.

The Witness: Not only to stay on it, but to attain it, and then maintain it.

Mr. Anderson: Very well.

I suggest that we adjourn now for lunch, then, Your Honor.

The Court: Yes.

We will adjourn now, gentlemen, to resume at 2:00 o'clock.

* * * *

[197] Mr. Anderson: Mr. Eddy, will you resume the stand, please.

Arthur Crooks Eddy

resumed the stand and, having been previously duly sworn, testified further as follows:

Direct Examination (resumed)

By Mr. Anderson:

Q. Mr. Eddy, you are still under oath, and for the record you are the same Mr. Eddy who was testifying this morning before adjournment; is that correct?

A. That is correct, yes, I am the same Mr. Eddy, and I am under oath.

Q. Would you please—strike that.

Mr. Anderson: Read back the last question and answer so we can pick up the continuity of the question, Mr. Reporter.

(Record read.)

By Mr. Anderson:

Q. In your study of the documents, facts relating to First Security Life Insurance Company of Texas, and policies issued by American National during this period of time, were [198] there any health requirements that you noticed that were necessary of the borrowers before they could take out this credit life insurance we were talking about?

A. No, sir.

Q. Was there any waiting period before the insurance went into effect?

A. No.

Q. What effect would this have, if any, upon mortality rates?

A. This is a form of very lax underwriting which would necessarily invite anti-selection, and also necessarily take into the insured risk group hazards or risks that were not as healthy as you might be able to get had you had selection.

Q. Would the effect be favorable or unfavorable on mortality rates?

A. This would tend to increase mortality rates, the likelihood of excess mortality.

Q. Explain to the Court what anti-selection means.

A. That is a term used in the industry to describe the arrangement whereby the insurer selects against the insurance company, having information which he thinks is important and may add to the mortality in his own particular case, or make his death or disability more likely than the underwriting rules perhaps that the company might anticipate.

Therefore, he sees a distinct advantage to buy [199] insurance under these conditions, whereas the company in its formal selection, not in the case of American National's policy here, but the normal protection procedures would try to exclude such people from their coverages.

Q. If I understand that, you mean a loan officer might sell his body with cancer——

Mr. Booher: I object to that as being argumentative.

The Court: Why don't you ask him to give us an example as to what he means.

By Mr. Anderson:

Q. Give us an example of what you were just talking about.

A. In case of credit insurance, there would be two cases of anti-selection, one from the policyholder himself, and this was and has been a concern in the credit insurance industry, that the borrowing public would become more sophisticated and knowledgeable about the opportunities with respect to credit life insurance coverages, and this has been indicated in studies that have been made that such is the case, that

individuals who have terminal illnesses frequently borrow money in order to get this insurance protection.

Another example of anti-selection that play in the credit insurance field is where the individual who is running the financial institution, let's say a banker, is in a position to select aganst the insurance carrier himself, [200] knowing his friends in the community who may be less than standard health risks, and suggesting to them to borrow.

Q. Does the size of volume—does the volume written by an insurance company have any effect on the company's actuarial position and, if so, what?

A. The volume of insurance in force has a considerable effect, because the probability is that you use or assume in rate-making or contrary the amount of monies you assume from a given premium available for mortality purposes, depend upon large numbers.

Chance fluctuations against small numbers of insureds or small amounts of insurance outstanding can occur and, therefore, destroy the averages.

Q. Would a small company or a company the size of First Security Life of Texas be in a favorable position with respect to this matter that you have just commented on?

A. Security Life of Texas has over the period of five years been gradually changing.

It is still at the end of 1959 a relatively small company with a considerable amount of risk, but with a chance of fluctuations not anticipated in the averages, at the outset it was very susceptible to.

Q. What about geographical area? Does that have any effect on actuarial position of the company?

A. With respect to credit insurance risks, the [201] concentration would be important. For instance, the catastrophies are more likely to occur with your clients who are all clustered in one small geographical area, for instance the disaster of Texas City is one.

This is definitely my opinion, that because of the relative concentration among its insureds.

Q. Have you expressed the opinion that Security Life needed the money that it took, and all of the money it took in, to stay on an actuarially sound basis? Have you prepared some charts which would help to explain to the Court the basis for this conclusion?

A. Yes, sir, I have.

Mr. Anderson: With the Court's permission, I would

like to have the witness step down from the stand to demonstrate these charts.

THE COURT: Permission granted.

MR. ANDERSON: Your Honor, we have marked these charts ourselves Exhibits 58 through 63. They were exchanged with Government counsel yesterday.

We will move for their admission into evidence after this testimony.

(The documents referred to were marked for identification as Petitioners' Exhibits Nos. 58 through 63, inclusive.)

THE COURT: Do you have a copy there?

[202] MR. ANDERSON: Yes, I will give a copy to the Court.

THE WITNESS: These are a little difficult to read and they might be easier to follow from the copies there.

THE COURT: Thank you.

Proceed.

THE WITNESS: In the construction of a gross premium for life insurance benefit or conversely as is the case here in the use of the various pieces of the gross premium which you have to use or sell in a competitive market, you have to consider the various benefits and expenses and cost elements and this diagram, although not very clear from these charts, are much clearer there, demonstrate the composition of the gross premium that should be charged for credit life insurance.

The three major elements are the benefits paid, investment income, which is really more appropriate for other types of insurance and expenses and profit margins.

The benefits break down into basically death and disability claims and withdrawal benefits. The death claims—or death claim benefits then can be further subdivided and it is in this subdivision that we find the main needs for retained earnings by a small and new life insurance company.

We have, first of all, the immediate claims.

These generally are the claims that you expect, based on the averages that you use as a mathematician.

[203] These are generally derived averages from studies of large groups of policy holders encompassing maybe as much as the large percentage of the entire insurance market.

Such may be the case in credit insurance, where the studies reveal that the average claim rate taking all policy holders together is a certain percentage of a certain premium.

The next column which you can not read from the chart has to do with the future claims which result from an increasing age problem and an increasing anti-selection problem.

Further, subdivided in the claims are claims that occur as a result of chance fluctuations.

The latest study of credit life insurance companies reveals that the smaller the company, or companies, the more drastic the fluctuations and the more likely the fluctuations can occur and as the company grows, the less likely fluctuations might occur.

However, the latest study indicates that credit life in general, there are chances among fluctuations over the averages assumed by the entire industry of large credit life companies.

Finally, we have claims that might result as a result of catastrophic happenings such as we had at Texas City, the Texas City disaster and the flu epidemic of 1918.

These were fluctuations in claims due to catastrophes [204] not anticipated in our normal premium rates or our immediate assumed.

Now, the future claims can be further subdivided due to an increasing risk, can be subdivided against the ageing of the insured and the increasing anti-selection.

Back about the mid '50's with credit insurance there was considerable concern about this increasing anti-selection hazard and since that time many companies have protected themselves to the extent possible with a very loose underwriting procedure which is generally the case with credit insurance, but by including in their policies or certificates certain health questions or elimination clauses in the event that some pre-existing condition was present at the time that the man purchased his insurance.

In other words, they would not have paid the claim had he died of a heart attack if at the time he purchased his life insurance he had already known that he had heart trouble.

The ageing of the insured in the credit insurance field was another problem that was a fear much among the companies in the mid '50's and this fear well warranted.

The latest study statistically of claim rate shows a substantial increase in the claim rates based on broad averages, since the 1958 report, which the 1958 report included the experiences of 1955 and 1956 on this business.

The subsequent report covers experiences of 1960 and [205] '61 and it indicates that there is this ageing problem.

In spite of the fact that during this same period of time the industry has benefited by a tremendous influx of new and younger lives, for instance, about 1955 the credit insurance in force in America was in the vicinity of ten billions of dollars which in itself is quite a change since the real activation of credit insurance programs back in 1945 or 1946, at which time there was less than one billion dollars in force, but the gross since 1955 through 1965 has been even more spectacular and has gone from slightly more than ten billions in force at the end of '65 just short of sixty billions in force and this influx of new lives and younger lives is due to the change in the economic community in our opinion and in the change in the attitude towards borrowing, and the change in the attitude toward insuring or protecting the loans thus made.

Now, that essentially describes our view of the distribution of a premium.

Now, each of these squares that I pointed out in particular—well, I have charts also demonstrating how they specifically might apply in this case and which will further demonstrate the point.

Shall I carry on?

By Mr. Anderson:

Q. Please, if you can, and I would ask you to make it [206] as brief as you can and yet make it meaningful to the Court.

A. With respect to the First Security Corporation, the First Security Life Insurance Company, they commenced business in 1954 with, as this chart shows, $12,500 of surplus.

There is a typographical error here.

The retention should be down one line and the surplus should be down one line.

The surplus accounting at the beginning of '54 was $12,500. At that time this company retained a maximum of a $5,000 risk on an individual life.

It would have required, as you may see, less than three

extra deaths to have made this company insolvent during 1954.

In 1955, its retention was still $5,000. And it would have required nine lives to have made the company insolvent.

You might also find it interesting to note that for Security Life in the year 1954 it would have only required three deaths of these maximum amounts and yet they had some 12,000 policy holders.

Now, to say that the reinsurance vehicle is anything other than a risk venture is to be naive and ignorant of the facts because clearly, if you can wipe out a company's surplus with three deaths, the chance fluctuation with a small group could easily occur.

[207] Q. Mr. Eddy, as you show further numbers on that chart, would you indicate to the Court insofar as you can, how many policy holders there were each year as compared to the number of lives it would take to wipe out that company if you have that?

The Court: I think that the record should show that we are talking about Exhibit 59.

The Witness: All right, 59, yes.

A. In 1954, the number of——

The Court: Just a moment.

And your testimony prior to this chart was concerned with Exhibit 58. That's just for the record.

Mr. Anderson: Thank you.

The Witness: All right.

A. At the year end 1954 there were 12,500 and six policy holders. The following year nine deaths would have been sufficient to eliminate the surplus amount, nine extra deaths at the maximum amount.

The company had 27,594 policy holders. The following year, 1956, 28 deaths required to eliminate surplus, the company had 34,388 policy holders.

And so on, and in 1959, the number of policy holders were 36,416. And this graph was drawn to demonstrate the magnitude of the risk involved or the possibilities of financial disaster for this company due to chance fluctuations [208] and due to its small size.

By Mr. Anderson:

Q. Could you relate that to a block on your chart 58 so that the Judge could relate 59 to 58?

A. Yes.

59 was intended to point out the problem in this square which refers to claims due to chance fluctuations and, of course, due, of course, to small numbers.

Q. Are you now moving to Chart No. 60?

A. Yes, sir.

Chart No. 60 is just shown to amplify the figures shown in the previous chart and to show the relationship of the total outstanding insurance risk of this company as compared to its surplus account.

In 1954 or by the end of 1954 the volume—beg your pardon.

This chart shows the average exposure during the year as compared to the surplus account at the end of the year.

I beg your pardon, again. To the average surplus during the year.

So at 1954 with an exposure of $3 million, the company had $22,000 of surplus.

In 1955 with the exposure of $10 million, the company had a surplus of $84,000 on the average.

[209] In 1959 with an exposure of $40 million, the company had a surplus of $40,000 on the average for that year.

This relates—or amplifies '59.

Q. Which block in '59? I mean '58?

A. The same one as the—the same one as before.

Q. This is an amplification of the same block on '58?

A. Yes.

Now, within the life insurance industry there is a very much used rule of thumb for new life insurance companies that is to establish it with capital and surplus of approximately 100 times its maximum risk on one life.

This is arbitrary and a rule of thumb, but it is also true that throughout the industry the amount that companies will retain on one life is closely in that neighborhood.

And here are a list of companies in 1955 and the capital and surplus accounts during that year or at the end of that year and the relationship in the final column of a single life—retention on a single life to that capital and surplus, the figure is very obviously—and this is just a sample of a couple of hundreds that we went through to determine what the business judgment of the insurance industry management considered to be a reasonable relationship.

The average for this group is about 62.62 which means it takes approximately a hundred and forty claims at

[210] the maximum amount to eliminate the capital and surplus account of these companies on the average.

Q. Can you relate this chart to Security Life of Texas?

A. Yes.

We are still referring to claims due to fluctuations, but now also in this and this would be more protection for a company against the catastrophic loss, so you might consider that this last chart which is No. 61 is in part a demonstration of the needs for capital funds, both to protect against chance fluctuations due to small numbers and also to protect the company's financial position against catastrophic losses.

Now, Exhibit 62 is to show for First Security Life over the period under consideration here the relationship of its capital and surplus account to a maximum retained on a single life.

As you see, in 1954 by industry standards or by industry averages, the maximum retention on one life was particularly high in comparison to its available funds.

Now, a company which has this arrangement should take every expedient that would allow it to increase its capital account, capital and surplus account, so that a chance fluctuation or a small disaster would not put it out of business.

Following the Security Life through the years '55 through '59, we find that they gradually did retain monies not needed for other purposes, for claims, expenses, to build [211] the capital and surplus account, so that they were by 1959 in a position to have a $10,000 retention on one life.

I might add that it is also beneficial to the owners of a life insurance company to retain the maximum amount possible within its capital frame work on a single life, since to buy insurance protection from another is to share part of the potential profits.

Those charts then were to demonstrate the points made with respect to chance fluctuations and with respect to the catastrophic hazards.

There is another and maybe more important reason why in the credit life business, life insurance companies of all sizes, small and large, should retain more money for protection against future losses.

And this has to do with what has in practice been occurring within the industry.

Credit insurance was practically unused before 1945. The volume in force at that time was something like 365 millions

which was less than one-fourth of one per cent of the insurance in force in America.

Well, after 1945 and as the credit and consumer restrictions, consumer credit restrictions, were reduced and credit became more available, credit insurance was used in an increasingly large measure as we have already mentioned.

In 1955, 10 years later, it had gone from 300 million [212] to 10 millions and 12 years later, it had gone from 10 millions to 60 millions or thereabouts in force.

Well, during that period of time the industry has been struggling from trying to determine how to measure it to determine what true loss ratios are there to determine what type of regulation should be imposed to protect policy holders.

It has done it with very poor statistics.

The original study in 1958 by Mr. Biddle and other people was wasted on statistical information derived from annual statements of life companies who were in the credit life business, in the credit life files.

The first such annual statement containing such information was for the year 1955. The study reported in 1958 utilized the information from 1955 statements and the 1960 statements.

It is unfortunate so much emphasis was placed on the material and information derived from those statistics, since for one person, at least, I know how difficult it was for the companies, for the industry to supply meaningful information, having been responsible for trying to determine such information for the company I was with at that time.

Much has been done to improve statistics since then. However, we are still far short of adequate to tell us one thing that we are going to need to know as time goes on and that one thing is what premium rates or what average [213] claim rates or what claim provisions should we make for credit life, depending on age?

Now, in 1954——

Q. May I interrupt just long enough to point out for the record that you were referring to Exhibit 63 and your last minute or so of testimony has been relating to Exhibit 63; is that correct?

A. I guess so. I think I am going between Exhibit 62 and Exhibit 63, however, I am building to describe what this table is supposed to demonstrate.

The practice in the industry has been to sell an individual policy either on a group basis—single premium policy, either on a group basis or individual basis for one dollar a hundred and this premium was arrived at by some one, and I know not whom or how or why, but it was developed through a group concept and a group of concept and a group approach.

In the group insurance business a group writing life insurance company will look at one employer who has many lives and he will take each individual life at his particular attained age, calculate a premium adequate for that individual for the amount of insurance he has and for his age and likewise for all other individuals in the included group, add them together and divide by the total amount to determine what is known as the life average rate.

This life average rate then is charged to in [214] practice each employee in the group during the period in which this premium rate applies.

Once each year the group insurance company redetermines this life average rate. What they have recognized is the fact that people increasing in advancing age are more likely to die than the people who are the youngest in the group.

It has been known in group life insurance since 1920 that any given employer may have an increase in his premium rate as years go on because his particular group of employees are maturing.

They are ageing. And thus he can expect—and in this respect, this is a point well communicated within the life insurance agencies—all employees expect this.

Well; credit insurance evolved from a group concept and the one dollar represents someone's opinion as to the life average rate.

It was generally accepted and in fact during the '50's and since that time, except for states in which regulations have restricted the use of the premium rate to a lower figure, two dollars still generally is used.

The part of the confusion as to the adequacy or inadequacy of the one dollar rate has been this tremendous influx of new young lives and the increase in volume in this business.

We haven't had an opportunity though, in my opinion, [215] we will have an opportunity and that it is underway.

As a matter of fact, we will have an opportunity to see

these average claim rates increase and there is evidence now between the study which was conducted and reported in '58 and the study which was conducted and reported last year, there is a definite indication that this is at work and is in truth happening.

The claim ratios have increased. I don't recall the precise figure, but approximately 20 to 30 per cent during that period of time, which has been barely, well, the periods covered were only six years spread.

Now, this chart then was to take for First Security Life, one policy holder. He is a policy holder out in some agricultural community. He is a borrower at the bank in 1954. He is 45 years old.

Now, it just so happens on the average, the borrowers of First Security Life or First Security Banks or First Security Corporation were about 45 at that period of time.

The American National contract provides for terminations of benefits or coverage at attained age 65.

Now, taking what is on this chart and advancing the man from age 45 to age 65, this will reflect what is going to happen and what has been happening with respect to that one individual.

[216] The fact that we as an industry are completely uninformed as to the true rate of increase in this man's cost is because we haven't gotten the statistical information to enable us to keep track of claim costs by age.

We don't have this information. To keep track of that, we have to conclude that by deduction and otherwise.

However, taking the man at 45 and taking the 1958 CSO table mortality which was chosen deliberately, not to represent credit life insurance mortality rates, because credit life insurance mortality rates, as should be and have been experienced by companies issuing unrestricted policies, lacking underwriting requirements, lacking waiting periods, should be higher than the '58 CSO mortality tables.

The '58 CSO mortality table covers insureds' lives and examined lives during the period under which we have in consideration and that's roughly the period, the year 1954.

It is not only illustrative, but conservative.

Now, following this man, he goes to the bank and he borrows $100. He stays in this position and as soon as he pays back the $100, he goes back and borrows some more.

He constantly and continuously is renewing and staying

in this pool. We charge him $1 a premium. Now, it is the——

THE COURT: You are talking about the $100 man, not the 3,000?

[217] THE WITNESS: Excuse me.

For the 3,000, it would just be $30.

THE COURT: Right.

THE WITNESS: Now, the fact that it has appeared until this date that the dollar premium was adequate, is to ignore what is really in practice developing in the credit insurance industry, and that is you have an increasing cost due to those people who have been in the pool for the longer period of time.

They are being subsidized today by younger people and larger numbers of younger people coming in and paying a dollar, but at some state at some time, in fact, it would probably be predictable that these claim ratios would have to increase within the next decade because of the slump in new births following World War II.

We are probably looking at a much reduced claim rate because of the influx of men in the economic society who were born during the War.

However, if you took a closed community such as a small town, of course, buying credit insurance from a local banker or some one else and remaining the clientele of that bank, eventually the dollar rate will be insufficient.

So that we do today is profit. According to our annual statement of accounting in 1954, when our men age 45 was that age, if he really had mortality in the average code [218] on that table, we had that area of profits.

Now, following that man until he retires, something has to change in our industry.

We are either going to have to say, "Well, we will cut him off when he gets above the buck," or we say, "We are going to raise the rates when the community gets above the buck, then we must save money now to offset losses then."

Anything else is a short term point of view. Anything else is less than realistic of the circumstances and the facts and the practice that is now generally under current in our society or in our insurance industry.

It seems to us that the problem of this ageing population is a very important consideration.

And that also if you had a stationary group, for instance, if you were the largest insurance company in the world, writing the most credit insurance than any other company and you had insurers from the youngest age to the oldest age and every year they all moved up with some new people moving in to fill up the spot so that every year the composition in the group was precisely the same, then you could say whatever your book profits were, were profits. You could spend them and wouldn't have to worry about the future. Until that situation occurs with this particular industry, then you are not going to be sound and you are not going to be adequately providing for the long-term losses that [219] can be generated.

That, I think, covers the charts that I have here.

By Mr. Anderson:

Q. I have just a couple of more questions and then we will terminate your examination, Mr. Eddy.

The Court: You may resume the stand, again, sir.
The Witness: Thank you.

By Mr. Anderson:

Q. Well, first, 1954, were mortality rates absolutely known in the credit life industry?
A. No, they were not.
Q. Were they fixed or variable?
A. Variable, of course.
It depended on the group.
Q. Have they ever become fixed?
A. Well, no. There isn't any such thing as fixed mortality. If your group is charged enough, your statistics are ample enough, you might be able to predict with reasonable accuracy what to expect from that same group in the future.
Q. What is considered adequate protection in the credit life industry against catastrophic hazards?
A. The industry hasn't set any particular standards, but the group insurance laws of some states, the group insurance laws of some states have required companies in the group insurance field, including the credit insurance, to accumulate a [220] catastrophic reserve equal to 50 per cent of one year's premium income.
The Federal Income Tax Law effecting life insurance companies which is the 1959 Act, also recognizes such re-

quirement by allowing a company to deduct a two per cent premium per year until it gets to this maximum 50 per cent of premium.

Whether or not the company sets up a liability or keeps the money in surplus, they are permitted to make this deduction, recognizing that catastrophoes can and do happen.

Q. If First Security Life Insurance Company of Texas had paid out 40 per cent commission during the years 1954 through 1959, would it have been such that it would have reamined in your expert opinion on an actuarial sound basis?

A. No, not for the amount of risk they had.

THE COURT: Did we admit these exhibits?

MR. ANDERSON: Petitioners offer for admittance into evidence Exhibits 58 through 63 for identification.

THE COURT: Any objection?

MR. BOOHER: No, your Honor.

THE COURT: They will be received in evidence.

(The documents previously marked for identification as Petitioners' Exhibits Nos. 58 through 63, were received in evidence.)

MR. BOOHER: I would like to qualify that and say however we do not have any objections to the illustrations [221] and the methods by which these exhibits have been prepared, we don't necessarily stipulate to the underlying fact shown in these exhibits.

THE COURT: Yes.

Cross-examination, Mr. Booher?

MR. BOOHER: No questions, your Honor.

THE COURT: Thank you, sir.

You may step down, Mr. Eddy. You are excused.

(Witness excused.)

MR. ANDERSON: Your Honor, we would like to have marked for admission into evidence three charts that were used by Petitioners in their opening statement.

That would be the chart shown in the corporate family group, both before and after the split-up and the business transaction in question.

These would be marked, I believe, —we have two other charts which we have not yet offered and may not—

Exhibits 66, 67 and 68. We move for their admittance into evidence.

THE COURT: Any objection, Mr. Booher?

MR. BOOHER: No objection, your Honor.

THE COURT: They will be received.

(The documents referred to were marked for identification as Petitioners' Exhibits Nos. 66, 67 and 68 for identification and were received in evidence.)

[222] THE COURT: Why have you jumped from Exhibit 63 to 66?

Are you planning on introducing 64 and 65 later?

MR. ANDERSON: Depending upon Mr. Tookey's testimony, we may have exhibits which we would like to introduce in rebuttal testimony, but that depends on what Mr. Tookey testifies to and we have numbered these other exhibits already.

THE COURT: Yes. I wanted the record to show it. Proceed.

MR. ANDERSON: That concludes the Petitioners' case.

THE COURT: Mr. Booher?

MR. BOOHER: The Respondent calls Mr. Clarence Tookey as a witness.

CLARENCE H. TOOKEY

was called as a witness on behalf of the Respondent, and, having been first duly sworn, testified as follows:

THE CLERK: Take the witness stand, sir, and for the record, sir, may we have your name?

THE WITNESS: Clarence H. Tookey, T-o-o-k-e-y.

THE CLERK: And your address, please?

THE WITNESS: My home address is 711 Craig Avenue, La Canada, California.

THE COURT: I think we will take a five-minute recess at this time.

(Short recess.)

[223] THE COURT: Back on the record. Please be seated.

Proceed with your direct examination, Mr. Booher.

Direct examination

By Mr. Booher:

Q. Mr. Tookey, what is your present occupation?

A. Consulting actuary.

Q. What are your duties as consulting actuary?

A. Giving advice to clients regarding rates and their activities in the insurance business.

Q. What experience and training have you had as a consulting actuary?

A. I have been a consulting actuary since I retired from Occidental Life Insurance Company on June 1st, 1961.

Q. What title did you hold when you were last employed by the Occidental Life Insurance Company?

A. Senior vice-president.

Q. What title did you hold prior to that of senior vice-president?

A. Actuarial vice-president.

Q. What is the nature of Occidental Life Insurance Company's business?

A. They write life insurance and personal disability insurance on a group basis and on the individual basis on the lives of people in all of the states of the United States, [224] except New York and all the provinces of Canada.

Q. Did you have any responsibility in setting the rates charged by Occidental Life Insurance Company on its insurance?

A. I did.

Q. Was it the practice of Occidental Life Insurance Company to have its actuarial department set those rates?

A. It was.

Q. Do the initials NAIC mean anything to you?

A. National Association of Insurance Commissioners.

Q. Have you been on any industry committees?

A. Yes, on a great many.

Q. Could you briefly list those committees?

A. I was on the Joint Group Committee.

I was on the committee for the New Mortality Table which was named the 1958 CSO, CSO standing for Commissioner Standard Ordinary.

I was on the Credit Insurance Committee which was a joint committee appointed by the American Life Convention and the Life Association—the Life Insurance Company of America.

And I was on a number of other committees as well as that, special committees.

We had a committee that dealt with the principles that should be followed in writing a group insurance.

We had committees that dealt with the agents who thought there was too much insurance being written on the group basis rather than on an individual basis.

[225] I think those are the main committees that I served on.

Q. I believe you referred to the Credit Life Insurance Committee.

What was the origin of this committee?

A. It was appointed by the American Life Convention and the Life Insurance Company of America to study the credit business and perhaps set down some rules.

The origin of it was certain hearings that have been held—some federal hearings and some state hearings where the percentage of the premiums being charged debtors or borrowers was so small that there was suspicion that the lenders were using the excess to get around the usury laws.

And the reason the insurance associations took this up was that they wanted, if possible, to work out some kind of rules or agreements so that the insurance business would not be tagged with the criticism that had been made regarding the very low loss ratios that were occurring under creditor life insurance.

Q. Did I understand you to say that the percentage charged borrowers was so small?

A. It was the percentage of the premium charged borrowers returned in claims that was so small.

Q. I see.

Does the phrase "CSO" mean anything to you?

[226] A. Well, that is what I mentioned a moment ago. It is the Commissioner Standard Ordinary and it is the adjective describing the table of mortality that is now in general use for valuation of liabilities of insurance companies.

Q. Would you please tell us something about the Occidental Life Insurance Company, your experience with this company and the manner in which rates were set by this company?

A. Well, rates were set by the actuary in the actuarial department.

Of course, the actuary always had a staff that did some

of the work, but he was responsible for authorizing all rates.

Q. Now, based on your experience, would you tell us briefly what rates, if any, we could characterize as commonly used rates in the credit life business between 1955 and 1959?

A. I think we would have to divide the business into two sections.

Under the business written on individual policies, the common rate was $1 for each $100 of indebtedness repayable in 12 equal monthly installments.

The other section of the credit life business was not as uniform as that because it was mostly written on group contracts and the rates would range all the way from slightly [227] over enough to pay the claims to perhaps as high as $1 per thousand in some cases.

However, the average rates under the group policies were much lower than the $1 a thousand.

Q. Did Occidental Life Insurance Company ever use a dollar per hundred rate while you were an officer of that corporation?

A. Yes, we did.

Q. When did Occidental Life begin operating in the credit life insurance business?

A. I think it was approximately 1932. Our first very large case was on the personal loans made by the Bank of America and in that case the bank was paying for the entire cost of the insurance out of the interest margin.

There was no charge being made to the borrowers. So that I forget what our rates were. This was our outstanding balance plan. The dollar rate we have been talking about is a single premium rate and that would amount to about $1.50 a month if you had it on the outstanding balance plan.

I think that our rate may have been six or seven cents. It was rather unimportant because we kept only 15 per cent at the beginning, returned any balance to the bank because they had advanced the entire cost and then later we dropped our retention to 10 per cent.

Q. What did that 15 and 10 per cent represent?

[228] A. What Occidental kept to pay taxes and cover its operating costs and also a substantial profit.

Q. And that sum was after the payment of claims, I assume?

A. That's correct.

Q. In your experience in the life insurance industry, was it common for lending institutions to ask for compensation for an insurance company for selling life insurance to their debtors?

A. I think it was fairly common, yes.

THE COURT: May I hear that question again, please, Mr. Reporter?

(Record read.)

MR. ANDERSON: May I ask that to be limited to a time? This gentleman has been in the business for some years as I understand it and his experience with credit life was around 1930.

THE COURT: If you want it limited, that's fine.

It is all right by the Court, as the way it stands now, the question and answer doesn't mean anything. So if you want it limited, fine, because it doesn't mean anything to the Court.

He may be talking about 1890 or 1960, but that is my observation and it is your case.

[229] By MR. BOOHER:

Q. In your answer to the last question, what specific period of time were you referring to in your answer to the last question.

A. I would say that it covers the time from the middle 1930's to the present date.

Q. Does the phrase "reversed competition" mean anything to you?

A. Yes, it does.

Q. What does this phrase mean to you?

A. I will illustrate it this way.

I will imagine that I am making a proposal to the lender and I will propose to the lender that I will use 75 cents instead of $1 and I will give the lender a 30 per cent commission so that the lender will get 30 cents out of the 75 cents as a commission.

My competitor goes to the lender and he says, "I charge $1, but I pay 50 cents —" I mean, 50 per cent commission, "so that you will make 50 cents on each unit of insurance instead of 30 cents."

Now, normally competition is on a question of price. And

normally my 75 cents would have gotten the business as against a charge by my competitor of $1.

However, if it is based on the return to the lender where he is getting 50 cents instead of 30 cents as a [230] commission, he may decide to accept the higher rate because of the higher commission and that is where the phrase regarding "reversed competition" came in.

Q. In connection with your work in the insurance business, and the connection with the setting of rates, is the phrase—or the term "representative cross-section" of any significance?

A. Well, I think that all that that would mean would be, do you have a—if it is connected with an actuarial concept—do you have a homogeneous risk?

In other words, you have a group. Has it the same average age, the same average mortality and so forth as white males in the United States? That might be one use of the expression "representative cross-section."

Q. Does the population of a particular state such as Utah or Idaho, contain a representative cross-section of individuals from an actuarial standard for life insurance purposes?

A. I think so because the premiums charged by companies doing business in all states would be the same in those states as they would be in New York, New Jersey or in California.

Q. Now, sir, have you made a study of the operations of the First Security Life Insurance Company of Texas in connection with its credit life, health and accident insurance for the years 1955 through 1959?

[231] A. I did, based on the figures that were furnished to me by the staff of the Internal Revenue Service.

Q. In your opinion, what profit did Security Life realize on credit insurance sold to borrowers to the First Security Banks during the years 1955 through 1959 which was reinsured with Security Life?

Mr. Anderson: This question is speculative.

I object. It calls for a conclusion that is not within the expert opinion of this gentleman's knowledge, since it refers to just profits.

What profit did they make? Now, what profit did they make is a very ephemeral factor, if I may say so.

Profit is profit. He is going to say that they took in

some money but some of it wasn't profit, maybe a question could be asked that maybe some of the money they took in wasn't profit or something, but what profit did they make is entirely vague and speculative.

THE COURT: I am going to permit the question and on cross-examination you can bring out the——

MR. ANDERSON: Well——

THE COURT: You can bring it out on cross-examination. Proceed.

THE WITNESS: Approximately one million dollars on the credit accident—life and accident and health business.

By MR. BOOHER:

[232] Q. How did you arrive at this opinion?

A. Well, I first took the amounts that have been paid in those years on the life and accident and health credit business, including a figure of approximately 228,000 and some odd in the form of unearned premium reserve and then I had to translate that into the premiums that were charged the borrowers.

The reason I had to do that was that the premiums received by the First Security were met of approximately 50 per cent that had been held out of the gross premiums by American National for their services.

In addition to the 15—that gave me a figure of approximately one million, nine hundred and fifty thousand dollars. I am leaving off the cents for simplicity.

The claims amounted to approximately $524,000.

Claim expense amounted to about $1800; the administration charge of American National, $202,500; and for taxes and general expenses, I had to prorate.

I found that the credit life and accident and health premiums were approximately 80 per cent of the total, so that I took 80 per cent of the total taxes and expenses which amounted to $20,363 and 80 per cent of that was approximately $16,339.

This gave me a total charge, expenses and claims of [233] $834,000 so that the company had left over about $1,115,000.

However, out of that, they had to set up their reserves. And those appeared to be approximately $106,000 so that I get a figure for the net profit of about $1,008,000.

Q. Now, sir, assuming a commission of 40 per cent of the net premiums paid by borrowers was paid on the credit life, health and accident insurance sold to customers of the

First Security Banks during the years 1955 through 1959, what was the amount of such commission paid and the amount of underwriting profit to First Security Life?

A. Well, 40 per cent of the gross premiums received from creditors which were approximately 1,950,000, 40 per cent of that is approximately 880,000.

So when—that is 780,000 rather.

So when that is deducted from 1,008,000, we get approximately $228,000 that would have been the profit if 40 per cent commission had been paid on the gross premiums charged to borrowers.

Q. What is your basis for these opinions as to the reasonableness of a 40 per cent commission?

A. Well, commissions ran on this dollar rate all of the way from 40 to more than 60 per cent.

The average commissions are shown in the investigation made by the insurance commissioners to which Mr. Eddy referred some time ago and 40 per cent is lower than the average [234] commission paid on the dollar rate, but we have to keep in mind here that we have American National's profit in that administration charge, so that having allowed American National a profit, the First Security wouldn't have been able to pay 50 or 60 per cent commission and still have shown any underwriting profit.

Q. Is your opinion on these matters based on your experience?

A. Primarily. I have worked—I have a number of clients that are in the business of credit life and accident and health. I was exposed to it for many, many years while I was with Occidental and I have been fairly active in the field.

It was largely at my urgings that we got the credit insurance law passed in the State of California which requires that the premiums be reasonable in relation to the benefits granted, and the dollar rate is no longer legal in California.

The maximum rate in this state now is 75 cents.

Q. And am I correct in understanding that what was stated in the report merely corroborates your opinion based upon your experience?

A. That's correct.

Q. Now, sir, what in your opinion is the normal method of an insurance company protecting its surplus?

A. Well, one way is not to take on too great a risk for

[235] the surplus that it has available. And many companies reinsure a substantial amount of their business because they don't feel that their surplus and capital are sufficient to justify a large retention on any one risk.

Q. Now, in your experience, sir, is it normal or customary to start an insurance company with $12,000 in capital?

A. Not in most states of the United States.

THE COURT: What year are you talking about?

MR. BOOHER: During the years 1955 through 1959, sir.

MR. ANDERSON: We ought to amend that. It is 25,000 capital, $12,500 surplus.

By MR. BOOHER:

Q. In your experience, was it normal to start an insurance company during the years 1955 to 1959 with an initial capitalization of $25,000?

A. No, it was not, in any state that I know of, except Arizona and Texas and I believe it was done in those two states.

California, at that time required $500,000 of capital and surplus.

Q. How long did the insurance reinsured by First Life Insurance Company of Texas during the years 1955 to 1959 run?

[236] MR. ANDERSON: I would like a clarification of the question, your Honor.

I don't know whether he is talking about the maximum provided for in the policy or whether this is experience derived from the actual bank data or what it refers to.

THE COURT: I think you better for my benefit get an answer to a question that is meaningful.

Do you want the question to stand? I will overrule the objection but——

By MR. BOOHER:

Q. In your study of the data furnished you concerning the First Life Insurance Company of Texas concerning the operations of this study for the years 1955 to 1959, what was the duration of the credit life, health and accident insurance reinsured by this company?

A. I only know from hearsay. I did not study their business.

MR. ANDERSON: Then I object to it.

The Court: There is no answer. He doesn't know.

Mr. Anderson: Very well.

The Court: If there is another question, then your objection will be proper, or I will sustain your objection.

By Mr. Booher:

Q. Have you prepared a report which illustrates the methods and procedures that you used in arriving at your [237] opinions that you have just given?

A. I have prepared a report from which I have just read the figures which I have given.

The Clerk: For identification, Respondent's Exhibit CK.

(The document referred to was marked for identification as Respondent's Exhibit No. CK.)

Mr. Booher: I offer Respondent's Exhibit CK for identification into evidence as Respondent's Exhibit CK.

Mr. Anderson: I would like to address myself to the motion just made by Respondent's counsel.

This was what was offered to us last night for examination. The Court will notice on the face of the report, the first page, that there are questions stated which are in the form of legal questions and these are statements in there that—phrases in there, used to the effect that the companies involved in this case are not dealing at arms length.

The term "arms length" which is a legal term arising under 482 is a legal conclusion in and of itself and the inferences in this report all are based upon this phrase.

Whether this expert feels that these people are dealing in arms length is not material. It is not within his expertise as an actuary. He is not qualified to state a conclusion as to whether businesses are dealing at arms length or not. We feel that it is materially prejudicial.

[238] The second objection that I have to the report other than the fact that it uses these legal phrases which state the conclusions of law and which are outside the ambit of this man's expertise, is at pages—well, they are not numbered on my copy, but they would have three, four, and five of the report, and they are based upon a simple mathe-

matical calculation, derived from an industry average table, provided for in a 1958 study.

And the objection to this particular aspect of the report is two-fold:

The first part of the objection is that the report is hindsight. The figures used in order to support Mr. Tookey's opinion were not made available to the industry until 1958.

We are talking about a company that was formed April 1st, 1954.

Now, the gist, in essence, of this report is that of a valuation report and a common rule in this Court as in other courts is that data after the date of valuation cannot be used, except in a corroborative manner.

The second aspect of the objection is that it is not directly responsive and relevant to the First Security Life Insurance Company of Texas. This is a mathematical calculation induced from a broad field to arbitrarily apply to one small company rather than deducted back.

[239] We feel that in that respect it is irrelevant. So for these three reasons, we would object to the report.

It may resolve the first objection if the Court is reminded of the fact that Mr. Tookey has just stated he has read his figures into the record.

Well, based upon the figures he has read into the record, the report is now before the Court and it is without the prejudicial language that I am objecting to, so counsel cannot complain that the figures and computations were not before the Court and the only thing that would be left in the report would be Mr. Tookey's phrasing of the questions presented and his conclusions in the legal manner.

The Court: Off the record.

(Discussion off the record.)

The Court: Back on the record.

Any further observations?

Mr. Booher: Your Honor, these comments of Petitioners' counsel go merely to the weight of the testimony as to the meaning of the term, "arms length."

Every expert who testifies in any type of valuation matter, must make some determination as to the relevancy of some comparative data.

To say something is or is not at arms length is a matter of opinion, but it is certainly not a legal conclusion.

As to this point, I am not sure I recall what counsel [240] is really referring to as a conclusion of law in this case.

Certainly Mr. Tookey is testifying as an expert actuary and not as a lawyer.

As to the report, using hindsight, he specifically testified that he based his opinion on experience.

This data was merely corroborative of his experience for which reasons I submit that the comments by Petitioners' counsel go merely to the weight of the opinion and not to the admissibility of the opinion or the report in evidence to illustrate the facts, methods and procedures that he used to arrive at this opinion.

The Court: Yes. The Court feels that all of your objections do go to the weight and your observations are on the record and they will be considered.

Mr. Anderson: Very well, your Honor.

The Court: The exhibit marked for identification as Exhibit CK is admitted into evidence.

(The document previously marked for identification as Respondent's Exhibit No. CK, was received in evidence.)

The Court: Do you have anything further, Mr. Booher?

Mr. Booher: I have nothing further.

The Court: You may cross-examine, Mr. Anderson.

[241] Cross-examination

By Mr. Anderson:

Q. Mr. Tookey, when you use a phrase, "arms length," is that a personal opinion or do you derive that from a book or a rule that we can cite to the Court?

It is a personal opinion, isn't it?

A. Well, I think it has a layman's meaning as well as a legal meaning——

Q. I am not asking the meaning.

Mr. Booher: The witness has not had an opportunity to finish answering the question.

Mr. Anderson: I am asking that he be responsive, if we can't get an answer to that question.

The Court: Let that question and answer stand and come forth with another question and see what develops here.

You can go back to this again. I am not precluding you from doing that.

Mr. Anderson: I will argue with—I will argue it on brief.

The Court: I think it is a matter more for brief, yes.

Mr. Anderson: Yes.

By Mr. Anderson:

Q. Page 3 of your report, Mr. Tookey, refers to Volume 1 of the 1958 proceedings of the National Association of [242] Insurance Commissioners.

Are the statistics derived following that statement on Page 3 taken from that report, sir?

A. You refer to the wording, "Page 128 shows the following averages for 1955 and 1956," is that it?

Q. Correct.

A. Those were taken from that report.

Q. You testified in local finance versus commissioner, a case before the tax court last summer, isn't that correct, sir, as a witness for the Government?

A. Yes.

Q. This report we just alluded to is the same report that was referred to in this colloquy on Page 332 of the transcript of those proceedings, stating—by Government counsel—"Question: Let me ask you this. Your opinion, sir, was it formed because of what was in that report you are talking about?

"Answer: No, it was not."

Is that the same report?

The Court: Did you follow that?

By Mr. Anderson:

Q. Does that sound familiar to you? Your opinion in the local finance case regarding Grand National was not based on this report, was it?

A. No, it wasn't.

[243] Q. You stated that your opinion in this case was based upon your experience in the industry.

To refresh your memory, on Page 332 and 333 of the local finance transcript——

Mr. Booher: If he is going to impeach the witness for prior inconsistent testimony, he should be giving the witness an opportunity to read this testimony before putting the question to him.

MR. ANDERSON: I will be happy to give him the transcript.

By MR. ANDERSON:

Q. Follow along with me, sir, and as I read——

A. Yes.

Q. Line 24—or 25 says, "Answer: One experience was studying the statements of several companies that have been almost 100 per cent, if not a hundred per cent in the credit insurance business.

"One of those companies is Grand National. Another of them was Alinco."

You testified for the Government in the Alinco case, too, did you not, sir?

A. That's correct.

Q. And going down to Lines 12 and 13, "Another source is a client of mine who writes practically nothing but creditors insurance and has a premium of around $8 million a [244] year.

"I know what his experience is."

Were these the companies you used to make up your experience in arriving at your conclusions, sir?

MR. BOOHER: Let me specify which opinion it is he is talking about, the one in this case here or the one in the case we have today?

MR. ANDERSON: The one in the case we have today.

By MR. ANDERSON:

Q. Are these the companies that you used in arriving at the opinion in your experience in the case we have today?

A. My opinion as an actuary?

THE COURT: That is a question which is going to require a yes or no answer.

Were these companies used at all in arriving at your opinion here today?

THE WITNESS: To some extent, yes.

By MR. ANDERSON:

Q. Were there other companies used in arriving at your opinion here today?

A. Possibly the First Security, after I received the figures on them.

Q. Any other companies?

A. (No response.)

THE COURT: Are you thinking or——

[245] THE WITNESS: I am thinking because I have a lot of clients and—is the question only with respect to my experience since I have been consulting?

THE COURT: Now, Mr. Tookey.

He is asking—he wants to know what you used in arriving at this conclusion, what companies? Now, you have stated you have used the same companies, that is, that you used in the prior report plus First Security and now is there any other company?

You should know that. Did you use any other company?

THE WITNESS: Perhaps I am confused, your Honor, but I am being asked my conclusion. I would like the conclusion read so I am sure of what I am being asked.

THE COURT: Your conclusion in this case?

THE WITNESS: My report in this case. All I gave in the report that is in evidence is a mathematical study of the figures that I was given on First Security, together with a quotation of figures that were published in this book of proceedings by the National Association of Insurance of Commissioners.

By MR. ANDERSON:

Q. Thank you.

Mr. Tookey, referring again to that report, I direct your attention to Line 21 on Page 333 of the local transcript [246] and tell me where the statement made on that line and the following line refers to the report you just made or the report you just identified. "Frankly, this report here is not in such shape that it can be used for anything except to see if in a large block of figures if there is any difference."

Does that refer to the same report that you just identified?

A. I would think so from reading it.

Q. Do the function of an actuary to make sure that there is virtually little or no risk for the policy holders of a company that the actuary is setting rates for?

A. No risks for the policy holders.

Q. No risk for the policy holders, is that the purpose in setting rates?

Mr. Booher: I object to that question as being too vague and indefinite to produce an intelligible answer.

Risk, in what sense of the word?

Mr. Anderson: Risks that they will not be covered, I suppose.

Mr. Booher: Covered in what sense? That the claims will be paid timely?

Mr. Anderson: I submit the question for ruling.

The Court: Read the question again, Mr. Reporter.

(Record read.)

The Court: Can you answer that?

[247] The Witness: I think he should set the rates so that his company won't go bankrupt and theoretically be unable to pay off its obligations.

By Mr. Anderson:

Q. What mortality or claim figures did you use in your report in arriving at your conclusion for this case?

What claim experience did you use, what figure?

A. If again, this opinion is the report that is entered in evidence, those are the figures of First Security.

Q. Mr. Tookey, would you have known those figures at April 1, 1954 or is this hindsight?

A. Well, I don't believe that I made any comment about what rate I would have set at the time if I have been setting the rate in 1954.

Q. Was there any guarantee in 1954 that First Security Life Insurance Company of Texas would not have losses greater than 30 cents on the dollar? Is there any absolute actuarial guarantee that that would not happen?

A. I don't believe an actuary can guarantee anything.

Q. In your testimony in the Alinco Life Insurance Company case, did you hear Mr. Stover testify that the overall loss for Old Republic Insurance Company was 38 cents on the dollar?

Do you remember that testimony?

A. I had forgotten that.

[248] Q. Do you know that American National Life Insurance Company has 50 cents loss on the dollar in the State of Utah?

Mr. Booher: I object to that question.

It has not been established in evidence as yet that this is a correct figure of American National——

Mr. Anderson: I am testing the witness.

The Court: It is proper. It is on cross-examination. Answer the question, sir.

The Witness: By that question, do you mean that on this dollar rate that we have been talking about, that the losses were 50 percent?

By Mr. Anderson:

Q. Fifty cents on the dollar claim experience in the State of Utah, the state we are talking about in this case?

A. No, I did not know that.

Q. Do you know that Standard Life and Accident Insurance Company in the State of Utah has loss experience of 58 cents on the dollar rate for credit life and 54 cents on the dollar for accident and health?

A. No.

Q. Is there any guarantee to a life insurance company of any size that they would not suffer losses of this magnitude?

A. The probability is remote and——

Q. The answer is, is there any guarantee that they would not suffer losses of this magnitude?

[249] A. I presume not, if an atomic bomb hit down or they lost one of those nuclear War Heads why——

The Court: Your answer is no?

The Witness: That's right.

By Mr. Anderson:

Q. Do you know that if it is established in evidence that American National is suffering a 50 cent loss rate in the State of Utah, that there has been a nuclear War Head on the State of Utah in the last little while?

Mr. Booher: I object to the last question and ask that it be stricken.

Mr. Anderson: I withdraw it.

By Mr. Anderson:

Q. You just testified that the purpose of an actuary is to protect policy holders on risks.

Mr. Booher: He did not so testify.

By Mr. Anderson:

Q. Is one of the purposes for—or of an actuary to protect policy holders from risks in setting rates?

A. I think the job of the actuary is to estimtae what reserves and what rates should be charged, so that the company will be solvent and be able to pay off its obligations.

I believe it is the insurance commissioner whose responsibility it is to see that the reserves are set up on a proper basis.

[250] The code in the State of California will not permit premiums to be charged below a certain basis without setting up reserves in advance.

I don't feel that the actuary has the responsibility of the financing of the insurance company entirely.

Q. Well, then, let me put it in another way and make sure that this is before the Court.

Is one of the responsibilities of an actuary to make sure that the rates keep the company in a safe position?

A. I don't know whether he can make absolutely sure of that. He uses probability, history, and rates that should with proper operation of the company, keep it solvent.

The actuary cannot prevent foolish operations on the part of the company management, such as losing money on their sales effort and so forth, so I don't see how the actuary can take the final responsibility of keeping the company solvent.

The Court: I think that the answer is probably yes. Isn't it, Mr. Tookey?

Don't you think that the actuary has some responsibility?

The Witness: He has some, but not the total responsibility.

The Court: Does that help any?

Mr. Anderson: Let's see if this helps some more.

[251] By Mr. Anderson:

Q. Page 329 of the transcript of the local says thus and so and read your testimony about that and maybe it will help some, beginning with Line 24.

A. Well——

The Court: The witness doesn't realize that these are different volumes of the testimony.

The Witness: What page am I supposed to be on?

By Mr. Anderson:

Q. Excuse me, Page 379 of the transcript, sir.

A. I see.

Q. This is your testimony and this is your answer on Line 24.

"Answer: Not necessarily minimum rate. I don't think when I was an actuary charged—I charged a minimum rate. I wanted the rate to be safe for the company."

Now, would that statement stand true as your opinion in this court today as it was in local finance?

A. That is correct, but I couldn't guarantee that it was sufficient. There is a difference in my opinion——

The Court: Now, Mr. Tookey, wait a minute.

There is only one question before you and that question is, do you agree now with the statement you made then, am I right, Mr. Anderson?

Mr. Anderson: That's right.

[252] The Court: Now, it takes a yes or no answer, Mr. Tookey, and then if you wish to amplify your answer, you may, but the Court wants you to answer that yes or no.

The Witness: I would say yes, but may I now amplify it?

The Court: Yes.

The Witness: That in the phrase, "The rates to be safe for the company," it is a rate that in my opinion and based on my experience and all the risks involved is most likely to produce a profit for the company and not to cause it a loss.

By Mr. Anderson:

Q. Assume with me, Mr. Tookey, that we have in evidence or will have in evidence the fact that there is a large life insurance company, American National, suffering a 50 cent loss rate in the State of Utah today on one dollar a hundred premium.

Let's apply your figures to this, a 50 cent loss. What was the retention to American National given by First Security Life, what percentage?

Mr. Booher: We are talking about 10 years ago.

That deals with today. If he can go back to '54 or '55, it might have something to do with this case.

By Mr. Anderson:

Q. Could the 50 cent loss rate happen at any time?

[253] You said before you couldn't guarantee what the loss rates would be. Haven't you said that?

A. The probability of a loss rate changing materially in a short time is extremely remote.

Q. Is it there?

Mr. Booher: If I may, your Honor, the Court has not yet ruled on my objection.

It is irrelevant.

The Court: The objection still stands, but I want a little more information here before I rule.

By Mr. Anderson:

Q. Is the problem—or probability still there?

A. I—a possibility, not a probability.

Q. Let's follow these figures.

The Court: I am going to overrule your objection.

I am going to let him testify. He is on cross-examination and I think that the objection should be overruled.

By Mr. Anderson:

Q. Let's follow these figures then, Mr. Tookey.

What was the retention to American National by First Security Life in this case during the years 1954 through 1959?

A. 15 per cent.

The Court: That would be 15 cents on the dollar, is that right?

The Witness: That's right.

[254] By Mr. Anderson:

Q. What was your suggested reallocation figure in your report?

Mr. Booher: I will object to this line of questioning.

It is apparently to develop a comparison between this company and American National on a 50 cent loss ratio. The facts are that this company upon which Mr. Tookey based his opinion did not have a 50 cent loss ratio.

If you assume a greater loss ratio, you are going to come out with a profit—

The Court: He is an expert. He knows this field and I think Petitioner has a right to attest the amount of foundation or strength of the opinion given by the witness.

And this is all that he is doing. I think it is proper.

Your objection is overruled.

By Mr. Anderson:

Q. What does the amount of the reallocation you suggest in your report—or the so-called unearned part of First Security Life's income? 40 per cent; is that right?

Don't you know what your report states?

A. I don't know what you are talking about, counsel. You have lost me.

Are you asking about the claim reserves?

Q. No.

[255] A. Or the small allocation of the expense that I made here for claim expense and pro rata tax in general?

Q. Your report starts out talking about assuming a 40 per cent reallocation.

Mr. Booher: The report does not state a 40 per cent reallocation.

The Court: What does it state?

By Mr. Anderson:

Q. What is the reallocation percentage?

Mr. Booher: The report does not tell—or deal with a reallocation.

The Court: Let Mr. Tookey answer, Mr. Booher.

I have to evaluate what this witness's opinion is worth.

By Mr. Anderson:

Q. Let me direct your attention to Page 2, "Percent of commission if 40 per cent had been paid." Is that correct?

A. That is merely a comment, your Honor.

Q. Is that—it is the basis for your figures and conclusion, isn't it?

A. Well——

The Court: Answer the question. He asked, it is a basis for your conclusion, isn't it?

The Witness: I am confused as to semantics here.

My conclusion—all I have done is put down the [256] mathematical figures here that would result as near as possible.

I showed the experience for five years and then merely said, "If 40 per cent had been paid."

The Court: The answer to the question is yes then.

I mean that is what the Court is concluding for the purpose of this record from this testimony.

By Mr. Anderson:

Q. Adding up then a 50 cent claim experience, a 15 cent retention, a 40 cents so-called commission out of the one dollar premium rate, how much do we have the company paying out?

Please, give me that total?

A. A dollar and five cents.

Q. Would that leave the company safe and solvent? Would that be a rate safe for the company?

The Court: Assuming that set of circumstances?

The Witness: No, it wouldn't, assuming those circumstances.

The Court: Well, I think we better give the reporter a break here.

We have been moving pretty fast.

We will recess for five minutes.

(Short recess.)

The Court: Back on the record.

[257] Be seated, please.

Resume the stand, Mr. Tookey.

By Mr. Anderson:

Q. Mr. Tookey, you made some statements on direct examination regarding "reversed competition."

Now, in states where premiums are competitive and the company in question is charging the competitive premium, is there any reversed competition?

A. I wouldn't think so on the business. I don't believe it goes by states, but on the business where the premium is —the amount of premium determines who gets the business, then, there would be no reversed competition.

Q. In other words, if it is a stndard rate, there is no reversed competition, is that it?

If it is a standard accepted rate, it is not reversed competition?

A. Well, if it were in a situation where the lender, if it was the lender that was taking out the policy or the seller, if it was a vender taking out the policy, who wanted the lowest rate that would give the insurance coverage, I don't believe there would be a standard rate because I think the various insurance companies would compete with one another.

They would try to assess that particular piece of business

and they would set their rates, based on their judgment of that piece of business and it would not be a standard level rate for everyone.

[258] Q. Would you kindly turn to Page 371 of the local finance transcript? It is in the smaller volume.

Do you have it?

A. Yes. That's the one I have.

Q. Line 10; were these questions propounded to you and were these your answers?

"Question: Is this higher compensation to an intermediary what you would call reversed competition, Mr. Tookey?

"Answer: I don't believe so, because we had to charge the same rates of premiums and be competitive with all the New York companies, because we were out in the open market.

"Question: In other words, if a premium rate doesn't change, then, there isn't any reversed competition?

"Answer: No, I don't believe so."

Were these your answers, sir?

A. They were.

Might I explain——

Q. I would like to go on and ask another question.

Please turn to Page 326 of the local transcript, sir. That's in the big volume.

A. The big volume?

Q. Yes.

A. I have it.

Q. Line 22; was this question propounded to you and was the answer that followed, your answer?

[259] "Did you have occasion during that time to consult publications and to meet with experts and other representatives of the credit life insurance industry with respect to rates and credit life insurance?

"Answer: Not particularly."

Was that your answer, sir?

A. Correct.

Q. Have you read volume 17 of the transactions of the Society of Actuaries of 1965?

A. No, I have not.

Q. Are you familiar with the fact that there is a study in the credit life insurance industry which supercedes the 1958 report which you referred to in your report?

A. I know there was the 1961 and '62 experience, I believe, that was reported in the proceedings, the 1964 proceedings, Volume 2 of the Commissioner's proceedings.

Q. This is a later report?

A. That's correct.

Q. Than the 1958 report?

A. That's correct.

Q. Are you familiar with the fact that on Page 329 of that report there is evidence that on—there are statistics shown that on units—that on creditor units—

Mr. Booher: I object to this question.

If he wants to determine whether the witness is [260] familiar with the statistics, he can hand the witness the document and the witness can say, "I am familiar with it or I am not familiar with it."

As it is now, he is reading into the record these facts.

Mr. Anderson: I am testing the witness to see if he is familiar with the existence of certain facts.

Mr. Booher: If he wants to find out if he is familiar with the facts, give him the document and the witness can say yes or no, so that matter which is not in evidence will not be read into the record in this case.

Mr. Anderson: This man here is an expert, your Honor.

The Court: I am going to let him proceed. If these matters are in the record, I am not going to pay any attention to them unless the witness says, "I am familiar with it."

If he is not familiar, then that fact also will go to the same weight. It is just like saying, are you familiar with anything in the volume? If he says, "No," then that's going to the weight too.

Mr. Anderson: We can offer it later.

The Court: You may proceed.

By Mr. Anderson:

Q. Are you familiar with the fact that this study shows that there were over 2,000 creditor units suffering a claim [261] experience of 50 cents and higher?

Mr. Booher: If I may——.

By Mr. Anderson:

Q. That is on the sale of credit life insurance?

The Court: I don't think this witness is familiar with anything there, is he? Because that is a study——

The Witness: Your Honor, I do have——

The Court: Just a moment.

I think what you better do—I don't know what you have in front of you. You better give it to the witness and ask him if he is familiar with anything in it because we could go all night on this.

Mr. Anderson: The point made originally was whether he was familiar with the later study than the one he quoted.

The Court: Is that the report you have? He stated that he hadn't read that report?

The Witness: I didn't state that, your Honor.

By Mr. Anderson:

Q. Have you read the 1965 study, Volume 17, the proceedings of the Society of Actuaries?

A. I have not read that. I knew that that report had been made. However, the report made to the Commissioners, I have read the original reports that were in typed form. I have not seen the printed form which is a proceedings like this.

However, I have right here in my briefcase, copies [262] of the typed report and I remember distinctly that there is a table in there, showing how many, how much of the business ran above 50 cents and how much of it ran down and on one of those tables, counsel may remember that the credit union showed something like 20 cents or 20 deaths.

Q. The credit union business is the best in the industry?

A. It is the best because I merely mentioned——

Q. Your report placed into evidence, does this note the twin dollar or borrow by check or mortgage placed into the First Security Life Insurance Company of Texas during the years 1954 through '59?

A. No, I was not asked for a report on those.

Q. Isn't the reason for that that the loss experience on those lines was as high as 120 per cent on twin dollars, 80 per cent on mortgage, isn't that the reason?

A. According to the figures I had, it was not that high, but I would have to go through my file here.

Q. Weren't the loss ratios considerably higher?

A. They were higher.

Mr. Anderson: That is all I have.

You may asked on redirect, Mr. Booher.

REDIRECT EXAMINATION

By Mr. Booher:

Q. In your report on Page 2, you show a commission of [263] $780,059.79.

In your opinion, would this have been a reasonable commission to be paid on the credit life, health and accident insurance for reinsurance to the First Security Life Insurance Company of Texas during the years 1955 through 1959?

Mr. Anderson: We are not talking about commissions, we are talking about a life insurance company and what it needs.

This is irrelevant.

Mr. Booher: This goes to the weight of the testimony. This is our theory of the case. The Court can give such weight to it as it desires.

Mr. Anderson: In addition, this is not redirect. This is beyond the scope of my cross-examination, since I didn't examine him on this point.

Mr. Booher: My understanding of the direct examination, and I can be wrong on this, is that we cannot cover this—my understanding was that I did cover this. Then in reviewing the cross-examination, there was some confusion on the record, apparently, as to whether this was merely a mathematical calculation.

So, it is proper redirect examination, and if it is not proper redirect examination, then in the interest of justice, I request the Court grant me authority to cross-examine on those. It will be no injustice to the Petitioners [264] whatsoever.

Mr. Anderson: This report has been admitted over your objection. That report, if it does not speak for itself, certainly should.

This is all counsel for Respondent should ask for. This is improper redirect.

The Court: Normally, it would not be proper redirect examination, but I think under the procedure that the Court urges here, I am going to let the question stand and permit an answer to it, but at the same time I am going to permit to that answer a different weight than I might give to it if it had come in the ordinary course.

The Witness: I think it is a reasonable rate of commission, although it is lower than the average commissions that were paid during that period on this type of business.

By Mr. Booher:

Q. Your report also shows an underwriting profit of $228,785.29.

In your opinion, would this have been a reasonable underwriting profit on the credit life, health and accident insurance reinsured with the First Security Life Insurance Company of Texas during the years 1955 through 1959?

Mr. Anderson: Same objection, your Honor.

The Court: Same ruling.

You may answer.

[265] A. I think it is reasonably, particularly taking into account the fact that American National is already taking a profit in their administration charge.

Mr. Booher: I have no further questions, your Honor.

The Court: Any recross-examination?

Mr. Anderson: Nothing further of this witness, your Honor.

The Court: Thank you, Mr. Tookey, you may step down. You are excused.

(Witness excused.)

The Court: Do you have another witness, Mr. Booher?

Mr. Booher: No, your Honor, we do not.

The Court: Are you resting?

Mr. Booher: The Respondent rests, yes.

Mr. Anderson: We have rebuttal witnesses, your Honor.

The Court: Call them, please.

Mr. Anderson: May I have a moment, your Honor?

The Court: Yes.

Mr. Anderson: I call Larry Harlan, please.

The Court: Off the record.

(Discussion off the record.)

The Court: On the record.

[266] Regarding the stipulation of facts, the clerk has pointed out that there is apparently an admission on the —is that the supplemental stipulation?

Mr. Watson: No. This is the basic agreed to stipulation with the joint exhibits. And apparently by inadvertence, Exhibit BZ 51(3) was omitted.

THE COURT: Fine, gentlemen. It is received in evidence and the stipulation will be amended to show the addition of that exhibit.

You can do it either by typing or writing it in on the original and conforming the copies.

(The document referred to was marked for identification as Joint Exhibit No. BZ(51) (3), and was received in evidence.)

W. LARRY HARLAN

was recalled as a witness on behalf of the Petitioners, and, having been previously sworn, testified further as follows:

THE COURT: This witness has already been sworn, is that right?

MR. ANDERSON: Yes.

THE COURT: Proceed.

DIRECT EXAMINATION

By MR. ANDERSON:

Q. You were the same Larry Harlan who was testifying previously in this proceeding, are you not?

[267] A. I am.

Q. You are still under oath?

A. Yes.

Q. Would you tell the Court what the claim loss experience on one dollar a hundred credit life insurance was in the State of Utah for the last two years?

A. The latest available figures we have was 47 cents the first year and 50 and six-tenths the second year.

MR. ANDERSON: I have no further questions.

THE COURT: Cross-examination?

CROSS-EXAMINATION

By MR. BOOHER:

Q. Does that pertain to the years 1966 and 1967?

A. 1964 and—wait a minute—1965 and 1966—wait a minute.

It is 1964 and 1965 figures. We do not have '66 figures available as yet. And they are on file with the State of Utah and the Utah Insurance Department.

The Court: So those figures are in 1964 and '65?
The Witness: Yes.
Mr. Anderson: No further questions, your Honor.
The Court: Any further cross?

By Mr. Booher:

Q. Do those figures relate solely to insurance sold to the customers of the First Security Banks?
[268] A. No, sir. This is all the business we have in force in the State of Utah, but it is all on the dollar rate.
Q. Is this on group policies the same as were in effect during the year 1954?
A. Yes, sir.

Mr. Booher: No further questions.
The Court: You are excused.

* * * *

Respondent's Exhibit AQ

First Security Corporation, Largest Intermountain Banking Organization, 79 South Main Street, Salt Lake City, Utah, February 10, 1959.

Thomas F. Hawkes, Vice President & Comptroller.

Mr. W. L. Harlan, Manager, Credit Insurance Division, American National Insurance Company, P.O. Box 8067, Dallas 5, Texas.

Dear Larry: On December 30, 1958, we forwarded a letter to you asking what would happen in the event the Reinsurance Treaties executed by the Officers of the American National and the First Security Life Insurance Company were cancelled. We received your letter dated January 2, 1959, in which you indicated that an agency contract would be executed with an agency of our selection whereby American National would pay a commission on any accident and health premiums being held by American National.

You also mentioned in your letter that you would be in Salt Lake City toward the end of January and I delayed making any further inquiries thinking that we could discuss the matter more fully when you were here. I understand you came to the office but were forced to leave in about 30 minutes because of some other pressing business. I was quite disappointed that I did not see you but we think the question should not be dropped at this time and that a definite understanding should be reached.

It was not stated in your letter of January 2nd, as to whether your letter pertained to all treaties or to just Reinsurance Treaty No. 2 covering Accident and Health coverage written on instalment borrowers in our "Timeway" Department.

Article VIII in the Reinsurance Treaty covering Real Estate Mortgage Loan Borrowers reads as follows:

"First Security shall have the right to cancel this treaty at any time by giving American National 30 days prior written notice of such cancellation. Notice mailed to American National at P.O. Box 8067 Dallas 5, Texas, shall constitute notice as provided herein.

In the event this treaty is cancelled by First Security as above provided, all outstanding certificates previously issued by American National hereunder shall cease to be reinsured with First Security as of the date of cancellation of the reinsurance treaty."

This refers to both Life and Disability coverages and in discussing the treaty with certain other officers, they state that Article VIII is not according to the understanding reached when the original arrangements were made.

We feel that we should be in possession of a letter from American National clarifying the situation as to what would happen should the reinsurance treaty be terminated.

I do not wish to appear super technical, but believe that our files should be complete in respect to this matter. Perhaps a letter or an agreement covering all business originating with First Security, that is, instalment loan, mortgage and "Twin Dollar" and not limited to any one division, would be in order.

Very truly yours,

Thos. F. Hawkes
Vice President

TFH:nj

First Security Bank Of Idaho, National Association; First Security Bank of Utah, National Association; First Security Bank of Rock Springs, Rock Springs, Wyoming.

Respondent's Exhibit AR

Credit Insurance Division, American National Insurance Company, P.O. Box 8067, Dallas 5, Texas.

COPY

January 2, 1959

Mr. George S. Eccles, President, First Security Bank of Utah, N.A., Salt Lake City, Utah.

Dear George: I have before me the new reinsurance treaties executed by the officers of American National and First Security Life.

In the event these reinsurance treaties should at some future date be cancelled it is understood that an agency contract will be executed with an agency of your selection whereby American National pays a commission on any accident and health premiums being held by American National.

For very good reasons, this matter cannot be mentioned in a reinsurance treaty, and I will cover this point with you the next time we can get together. Incidentally, I am going to the West Coast sometime around the 20th of January, and I am planning on coming back by Salt Lake somewhere around the 1st of February, provided you are in Salt Lake at that time. Please drop me a note as to what your travelling plans are between the 28th of January and the 5th of February.

Sincerely,

W. L. Harlan

WLH:lwc

Respondent's Exhibit AS

First Security Corporation, Largest Intermountain Banking Organization, 79 South Main Street, Salt Lake City, Utah, December 30, 1958.

Thomas F. Hawkes, Vice President & Comptroller.

Mr. W. L. Harlan, Manager Credit Insurance Division, American National Insurance Company, P.O. Box 8067, Dallas 5, Texas.

Dear Larry: We return to you herewith two copies of each of the new treaties forwarded to us with your letter dated December 23, 1958.

The question came up when the new treaties were being signed as to whether a clause should be inserted in Reinsurance Treaty No. 2 to cover the payment of commissions

should the ceding of premiums be discontinued to the First Security Life Insurance Company. This, of course, would also apply to the Mortgage contract.

We are also wondering if it is necessary that the signing of these contracts be authorized in the Minutes of a Director's Meeting.

Very truly yours,

/s/ Tom

THOS. F. HAWKES
Vice President

TFH:nj

Enclosures

RESPONDENT'S EXHIBIT BE-37

Minutes Of Meeting Of Executive Committee

First Security Corporation—April 1, 1954

* * * *

A meeting of the Executive Committee of First Security Corporation was held in Salt Lake City, Utah, April 1, 1954 at 10:30 A.M.

Present: George S. Eccles; M. S. Eccles.

George S. Eccles acted as Chairman of the meeting, with M. S. Eccles acting as Secretary.

First Security Life Insurance Company Of Texas

The Chairman stated that for the past several months consideration had been given to the incorporation of an insurance company for the purpose of writing credit life insurance in connection with our Consumer Credit Department as well as to write term insurance in connection with mortgage loans. He reviewed briefly the advantages of such a plan, including tax savings on premium income, and the fact that a life insurance company incorporated under the laws of Texas, may own an office building. By organizing our own company we would be qualified to either insure or reinsure.

The committee authorized the management to proceed with the incorporation of an insurance company to be known as "First Security Life Insurance Company of Texas" to be incorporated under the laws of the State of Texas. Paid in capital to be in the amount of $25,000.00 with surplus of $12,500.00. The officers of the company to be as follows:

George S. Eccles—President and Director.

D. Owens Thurman—Vice President, Asst. Secretary & Director

Rulon E. Jones—Vice Pres., Asst. Treas. & Director

J. D. Evans—Vice President and Director

V. R. Steffensen—Vice President and Director

Thos. F. Hawkes—Secretary, Treasurer and Director

S. J. Quinney—Director

It is anticipated that the new bank and office building being erected at Fourth South and Main Streets in Salt

Lake City may be carried in the name of the insurance company.

First Security Savings And Loan Association

The Committee discussed the organization of a Savings and Loan Association to operate at various points in Utah. It was felt that in view of the favorable tax provisions affecting such concerns and in view of our extensive activities in mortgage loan financing as well as the favorable competitive position Savings and Loan Associations are in, due to the higher interest they are able to pay because of tax benefits, it would be advisable to incorporate a Savings and Loan Association under the laws of the State of Utah.

The management was authorized to file incorporation papers and apply for approval from the State Banking Department for the incorporation of "First Security Savings and Loan Association", with the purpose of establishing branches at Provo, Ogden, Salt Lake City and Sugar House. The new company to have authorized capital of $250,000.00 of which $25,000.00 would be subscribed at the present time. Officers of the company to be as follows:

V. R. Steffensen—President and Director
S. R. Neilson—Vice President and Director
C. Verl Benzley—Secretary, Asst. Treas. and Director
Thos. F. Hawkes—Treasurer, Asst. Sec. and Director
S. J. Quinney—Director

Federal And State Taxes

The Chairman presented a schedule of Federal and State taxes paid for the year 1953 by First Security Corporation and its affiliates.

Company	Federal	State	Total 1953	Comparison 1952
First Security Bank Idaho—				
Normal & Surtax	817,288.27	79,303.93	896,592.20	1,024,564.81
Excess Profits	—0—			
First Security Bank Utah—				
Normal & Surtax	1,097,309.65	45,097.71	1,176,925.36	1,137,175.19
Excess Profits	34,518.00			

Company	Federal	State	Total 1953	Comparison 1952
Rock Springs	28,402.26	—0—	28,402.26	20,020.89
First Security Corp.	119,828.03	—0—	119,828.03	106,963.64
First Security Co.	74,503.22	2,656.49	77,159.71	68,053.73
First Seurity Bldg. and Loan	—0—	—0—	—0—	—0—
First Security Ins. Agency	14,357.20	1,379.07	15,736.27	19,752.05
Ed. D. Smith & Sons	30,211.69	1,561.00	31,772.69	19,920.12
Idaho Investment Co.	1,434.28	—0—	1,434.28	1,632.41
Western Investment Co.	11,208.35	1,395.49	12,603.84	2,757.22
	2,229,060.95	131,393.69	2,360,454.64	2,400,840.06

Construction Of Bank And Office Building
Salt Lake City, Utah

The committee discussed the proposed contract to be entered into with Utah Construction Company for the construction of the new twelve-story bank and office building at Fourth South and Main Streets in Salt Lake City. The management was authorized to enter into a contract with the Utah Construction Company for said purpose on a cost-plus-fixed-fee-basis to provide for a construction fee in the amount of $150,000.00, (to be payable $12,500.00 per month). The construction fee is based on an estimated cost of $2,500,000.00. The contract to further provide that in the event the cost exceeds $2,500,000.00, the Utah Construction Company shall receive 7½% of the amount of the excess.

There being no further business, the meeting was adjourned.

Chairman

M. S. Eccles
Secretary

RESPONDENT'S EXHIBIT BV-45

Commissions Paid to Ed. D. Smith & Sons by Credit Life of Springfield and American Bankers Life For Their Respective Years For the Period 1949-1954.

These amounts were reported, respectively, as Taxable Income by the First Security Company on the Tax Return of the First Security Company For Each Year Indicated.

1949	$ 3,682.88
1950	5,886.80
1951	20,327.42
1952	41,240.10
1953	60,343.74
1954	15,884.37

PETITIONERS' EXHIBIT 53

EXAMINER'S COMMENTS

Exhibit No. 88

Resources				Loss
All loans and discounts				160.39
Overdrafts				
Premium on Bonds				
Bonds, securities, etc.				
Banking house				
Furniture and fixtures				
Other real estate				
Cash items				
Shortages				
Other (describe)	Suspense			11.23
TOTAL	173,269.36	1,917.56		171.62

Was request made that the estimated losses be charged off? Yes.
Were the entries made during the examinations? No. To be charged off when authorized by Head Office.

VERNAL

EXAMINER'S COMMENTS ON MATTERS REQUIRING ATTENTION

(Include comment on ~~items~~ in previous report of examination which have not been satisfactorily adjusted)

Considerable increase in classified assets is noted at this examination, in addition to a heavy volume of Other Loans Especially Mentioned. Several illegal real estate loans are also noted, all of which indicates a general relaxation of policies. Local drouth conditions are partially responsible for the volume of criticized assets.

INSURANCE AGENCY

The branch operates an insurance agency in violation of Paragraph 11, Section 13, Federal Reserve Act, and has done this since the branch was acquired. The insurance department sells a complete line of life insurance, accident insurance, etc., and the personnel of this department also act as regular branch personnel, with one individual appointed Assistant Branch Manager, and an active member of the loan committee. These personnel are included in the branch payroll, and income from their operations goes directly into branch earnings. This violation of law should be removed as soon as possible.

INSURANCE DEPARTMENT — EXCERPT from Bank's L-107 dated 4-2-63.

In the loan review, Mr. Chester J. Tarleton brought our attention to what he thought was a violation of Paragraph 11, Section 13 of the Federal Reserve Act in connection with our insuran department. He stated that our insurance department ~~was in~~ violation because of the fact that in interpreting this Section that the Head Office was a place that the population figure should be based on. Our last census of Vernal shows a population of 3,612 and this Section of the Act indicated that banks cannot have an insurance department if the town in which they act in is more than five thousand population. Therefore, I feel that this criticism is unjustified in as much as we have been acting underneath this law every since I came to Vernal and before that and that the law is based upon the town in which the insurance is sold and the insurance is sold in Vernal, Utah and not in Salt Lake City, therefore, I think this criticism by the bank examiner is unjustified.

167. Review

In creditor's action to enforce judgment against newly chartered national bank to which assets of debtor bank had been transferred where creditor's counsel expressly stated that liability was sought to be imposed on theory that there had been a merger of debtor bank and new bank and case was tried on that theory, issue of whether transfer of assets by debtor bank to new bank was made in contemplation of insolvency was excluded and could not be considered on appeal. Pankey v. Hot Springs Nat. Bank, 1941, 119 P.2d 636, 46 N.M. 10.

Where on appeal from judgment dismissing national bank receiver's action against receiver of state savings association for value of alleged assets of bank pledged to association receiver and transferred by him under district court's order, bill of exceptions, settled by stipulation did not contain record of evidence pertaining to transactions relating to pledge of assets and their subsequent transfer, or statement that record contained so much of evidence as was necessary to explain alleged errors, court could not consider questions whether assets were pledged as security for a loan or deposit, or whether bank was owner of assets at time of transfer and whether, therefore, transfer was void. Tobin v. Seaborn, 1938, 82 P.2d 748, 85 Neb. 422.

§ 92. Acting as insurance agent or broker; procuring loans on real estate

In addition to the powers now vested by law in national banking associations organized under the laws of the United States any such association located and doing business in any place the population of which does not exceed five thousand inhabitants, as shown by the last preceding decennial census, may, under such rules and regulations as may be prescribed by the Comptroller of the Currency, act as the agent for any fire, life, or other insurance company authorized by the authorities of the State in which such bank is located to do business in said State, by soliciting and selling insurance and collecting premiums on policies issued by such company; and may receive for services so rendered such fees or commissions as may be agreed upon between the said association and the insurance company for which it may act as agent; and may also act as the broker or agent for others in making or procuring loans on real estate located within one hundred miles of the place in which said bank may be located, receiving for such services a reasonable fee or commission: *Provided, however,* That no such bank shall in any case guarantee either the principal or interest of any such loans or assume or guarantee the payment of any premium on insurance policies issued through its agency by its principal: *And provided further,* That the bank shall not guarantee the truth of any statement made by an assured in filing his application for insurance. Sept. 7, 1916, c. 461, 39 Stat. 753.

Notes of Decisions

1. Authorization of agency

This section expressly authorizes national banks in small places to act as agents for insurance companies, and hence contract of national bank in a village to procure insurance is not ultra vires. Marshall Nat. Bank & Trust Co. v. Corder, 1938, 194 S.E. 734, 169 Va. 606.

2. Guaranteeing loans

Under this section a national bank is prohibited from guaranteeing payment of principal or interest of loans notwithstanding loans are made on its own account and that, in selling notes secured by mortgages, it deals with its own property. Genesee Trustee Corporation v. Smith, C.C.A.Mich.1939, 102 F.2d 125.

A bank is prohibited by this section from guaranteeing payment of the principal and interest of a loan, and such prohibition is in effect violated where a national bank in selling a real estate

mortgage held by it enters into a contract for its repurchase whenever requested to do so. Moreover, although the bank has received the benefits of such a contract, it is not estopped, when sued thereon, from setting up as a defense the want of authority to make the contract. Greene v. First Nat. Bank of Thief River Falls, 1927, 215 N.W. 213, 172 Minn. 310.

2. Revocation of license

Action of state commissioner of insurance revoking license of Michigan corporation to write insurance as an agency was authorized by evidence, where it appeared that activities of Michigan corporation were controlled by a national bank, and that bank by indirection obtained license in name of Michigan corporation to evade Comp.Laws Supp.1940, §§ 12339, 12344 and this section which prohibited bank from securing a license in its own name. Washington Agency v. Forbes, 1944, 16 N.W.2d 121, 309 Mich. 683.

§ 93. Violation of provisions of chapter; forfeiture of franchise; personal liability of directors

If the directors of any national banking association shall knowingly violate, or knowingly permit any of the officers, agents, or servants of the association to violate any of the provisions of this chapter, all the rights, privileges, and franchises of the association shall be thereby forfeited. Such violation shall, however, be determined and ajudged by a proper district or Territorial court of the United States in a suit brought for that purpose by the Comptroller of the Currency, in his own name, before the association shall be declared dissolved. And in cases of such violation, every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other person, shall have sustained in consequence of such violation. R.S. § 5239; Mar. 3, 1911, c. 231, § 291, 36 Stat. 1167.

Historical Note

References in Text. Words "this chapter" in section, see note under section 21 of this title.

Codification. Act Mar. 3, 1911, cited to text, conferred the powers and duties of the circuit courts upon the district courts.

Derivation. R.S. § 5239 derived from Act June 3, 1864, c. 106, § 53, 13 Stat. 116, which was the National Bank Act. See section 38 of this title.

Notes of Decisions

EXHIBIT

PETITIONERS' EXHIBIT 54

BANKING LAW

Exhibit No. 54

Exhibit No. 54

[illegible]

§ 83. Acting as [illegible] real estate.

In addition [illegible]

[illegible]

shall in any case guarantee either the principal or interest [illegible]

[illegible] and providing further, that [illegible]

[illegible] 1914 c. 101 [illegible]

Words of [illegible]

[illegible]

EXHIBIT No. 56

October 17, 1955

Mr. W. L. Harlan, Manager
Credit Life Division
American National Insurance Company
c/o P. O. Box 8067
Dallas, Texas

Dear Larry:

From time to time I have discussed with you some of the other activities which are contemplated for First Security Life Insurance Company. You told me it might be a good idea to send in a report to our head office in Dallas, Texas. As I am not sure just whom I should be writing, I am sending this letter to you, with the hope that you will place it in the proper hands and see that I receive any necessary instructions. The following matters should be of interest to our head office staff.

Under date of January 4, 1955, First Security Life Insurance Company of Texas was authorized by the Federal Housing Administration, Washington, D. C. to act as an approved mortgagee under the provisions of Title II, Title VI, Title VIII, and Title IX of the National Housing Act. Our Certificate is numbered 19591 and is dated January 4, 1955.

In addition, under the direction of our general counsel, Mr. S. J. Quinney of Ray, Quinney and Nebeker, Kearns Building, Salt Lake City, Utah, we received approval to do an investment business in the State of California. One of the principal reasons for acquiring the right to do business in California, as well as becoming an FHA approved lender, was for the purpose of financing and servicing 196 individual mortgages to be made in Richmond, California pursuant to the provisions of Section 213 of the National Housing Act. Prior to the granting of the 196 individual mortgages, three separate blanket mortgage loans will be made on properties in Richmond, California by First Security Life Insurance Company, as mortgagee. These loans are identified as follows:

Project No. 1	$841,350.00
Project No. 2	752,000.00
Project No. 3	538,100.00
Total	$2,131,450.00

First Security Life Insurance Company of Texas appears as mortgagee on these mortgages, but has arranged to sell the following participations:

First Security Bank of Utah, National Association, Salt Lake City, Utah	24%
Bankers Trust Company, 16 Wall Street, New York, N. Y.	75%

This will leave the life insurance company with a 1% investment in the mortgages above referred to. Initial service charges of 1½%, amounting to approximately $32,000.00, will be earned by the insurance company for negotiating this financing.

In addition to the initial service charges, the life insurance company will, besides receiving interest at 4½% on its 1% investment in the mortgages, receive a servicing fee equal to ½ of 1% on the participations held by others.

It is expected that the three blanket mortgage loans herein referred to will be superseded and replaced by 196 individual mortgage loans bearing interest at a rate of 4½% per annum. Arrangements have been made with the First Security Bank of Utah and Bankers Trust Company of New York to purchase the individual FHA mortgages which will emanate from this financing, with the servicing of the individual mortgages to be retained by the life insurance company at its office in Richmond, California, at a servicing fee of ½ of 1% per annum. In this connection, arrangements have been made with Utah Construction Company of Richmond, California, for quarters to house mortgage operations of the company in that area. Utah Construction Company will also furnish one or more employees to perform the servicing work of the company in that area. The insurance company will be billed monthly for this expense.

It is my understanding that all items of profit and expense are to be reported to our head office in Dallas at least monthly. In addition, as soon as mortgage loans are nego-

tiated, the detail with regard thereto is to be reported immediately to our head office in Dallas, Texas.

If there are any other suggestions or instructions regarding our proposed activities, please advise.

Very truly yours,

/s/. V. R. Steffensen,

V. R. STEFFENSEN,
Senior Vice President.

VRS/jmg
co: Mr. Thos. F. Hawkes

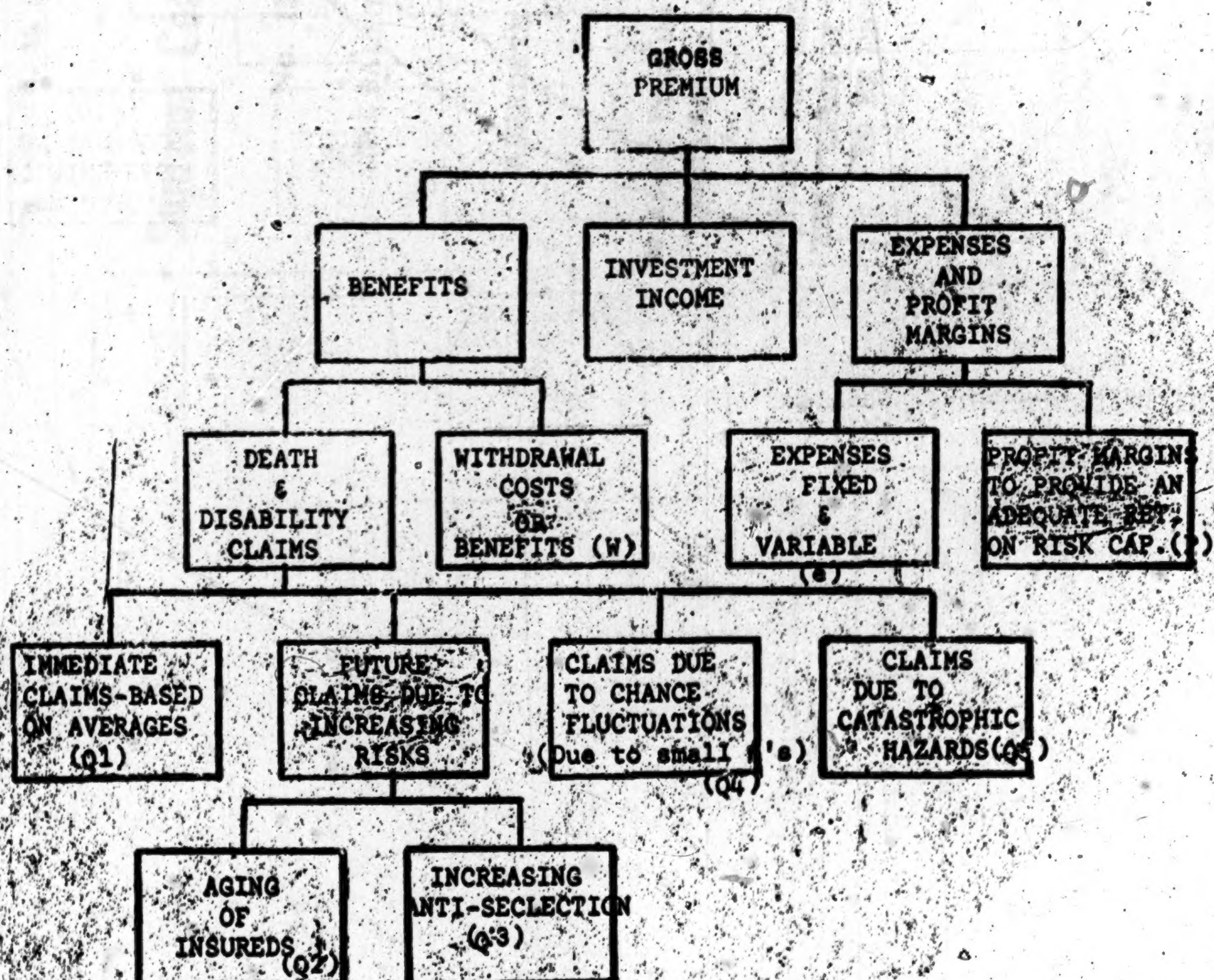
PETITIONERS' EXHIBIT 58

CHART

EXHIBIT 88
58

GROSS PREMIUM ELEMENTS

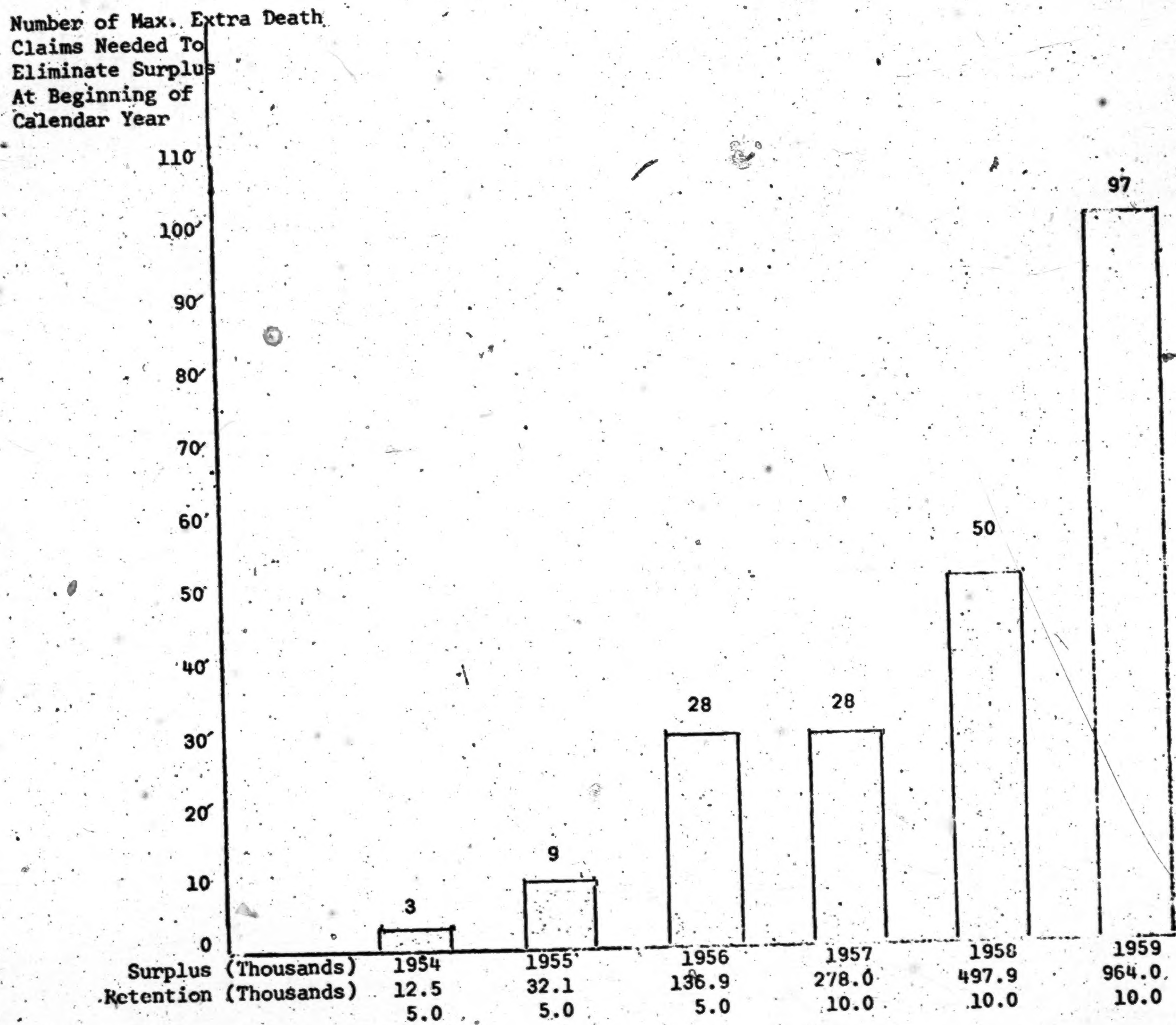
(Life & Disability Benefits)



$$P + (Q_1 Q_2 + Q_3 Q_4 + Q_5) + w - i + e + p$$

EXHIBIT 59

FIRST SECURITY LIFE INSURANCE COMPANY OF TEXAS



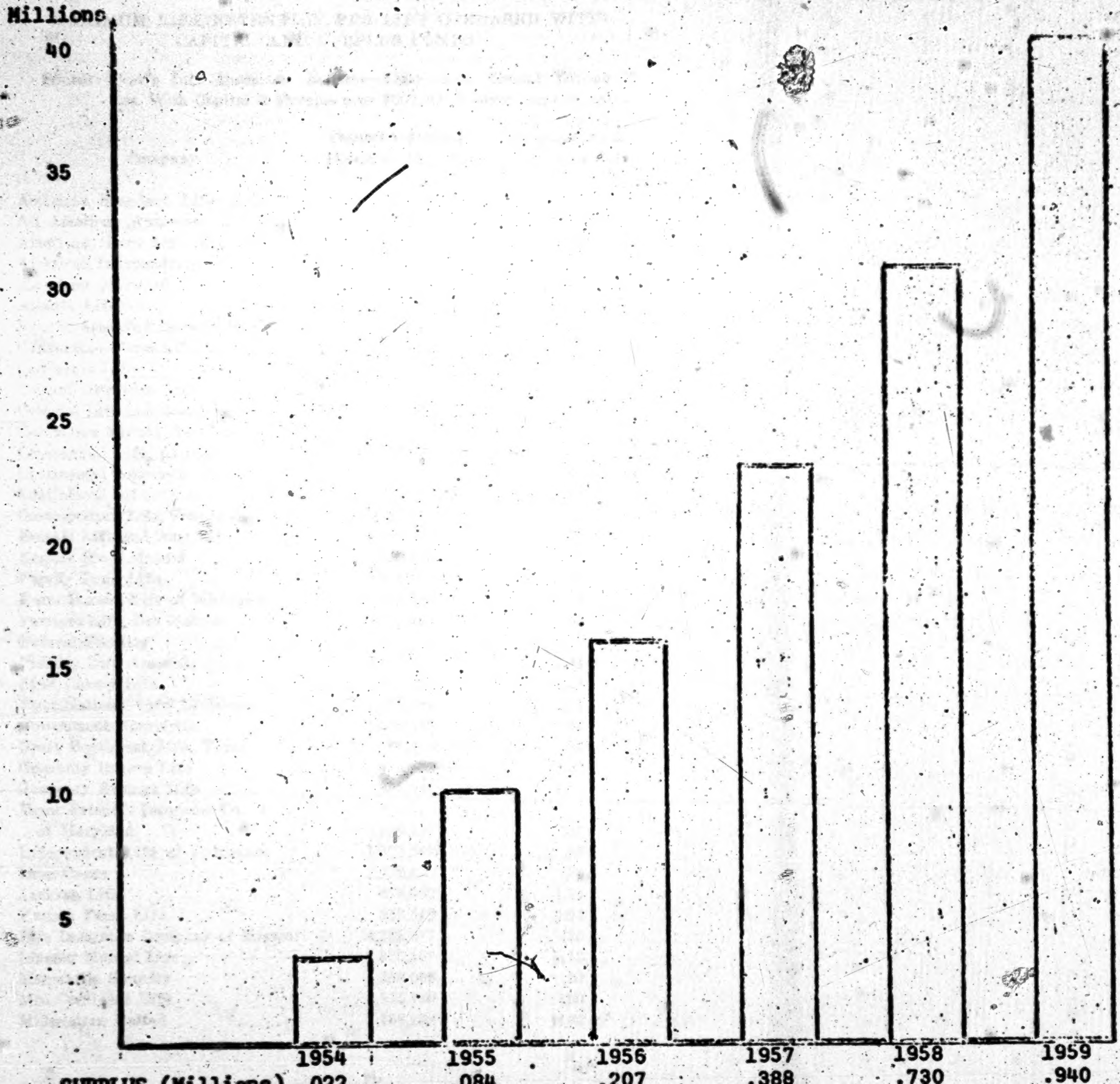
PETITIONERS' EXHIBIT 59

GRAPH

EXHIBIT 60

FIRST SECURITY LIFE INSURANCE CO. OF TEXAS

AVERAGE AMOUNT AT RISK RELATED TO AVERAGE SURPLUS



[redacted] PETITIONERS' EXHIBIT 60

GRAPH

PETITIONERS' EXHIBIT 61

MAXIMUM RISK RETENTION PER LIFE COMPARED WITH CAPITAL AND SURPLUS FUNDS

Source: Best's Life Insurance Reports—Fifty—first Annual Edition
Cos. With Capital & Surplus over $500,000 & Retention $10,000

Company	Capital & Surplus December 31, 1955	Retention As A % of Cap. & Surp.
		%
American Standard Life—D.C.	2,456,985	.41
All American Assurance of Louisiana	494,881	2.02
American Home Life, Kansas	358,444	2.79
American Independence Life	741,628	1.35
American Standard Life, Texas	871,868	1.15
Atlanta Life	11,749,963	.09
Benefit Assoc. of Railway Employees	4,516,199	.22
California—Farm Life	666,982	1.50
California Life	744,001	1.34
Central American Life	120,872	8.27
Colonial Life and Accident	1,912,434	.52
Columbian Mutual, Tennessee	301,065	3.52
Commercial Life, Arizona	709,647	1.41
Continental American, Texas	605,123	1.65
Continental Life, Texas	1,344,045	.74
Cosmopolitan Life, Tennessee	2,517,174	.40
Empire Life and Accident	3,076,729	.33
Empire State Mutual	720,407	1.39
Family Fund Life	913,036	1.10
Farm Bureau Life of Michigan	561,264	1.78
Farmers Life, Des Moines	791,467	1.26
Federal Security	620,125	1.61
Fidelity Life Association	2,463,292	.41
First Colony Life	421,008	2.38
First National Life, Louisiana	4,321,723	.23
Government Employees	1,028,329	.97
Great Southwest Life, Texas	721,478	1.39
Guaranty Income Life	441,433	2.27
Guaranty Savings Life	609,140	1.64
Home Friendly Insurance Co. of Maryland	2,696,198	.37
Independent Life of Baltimore	1,173,269	.85
Inter-Ocean	2,772,685	.36
Jackson Life	878,902	1.14
Kansas Farm Life	352,599	2.84
Life Insurance Company of Missouri	4,261,677	.23
Lincoln Mutual Life	1,375,107	.73
Mercantile Security	4,390,095	.23
Med-Continent Life	1,815,149	.55
Midwestern United	1,486,188	.67

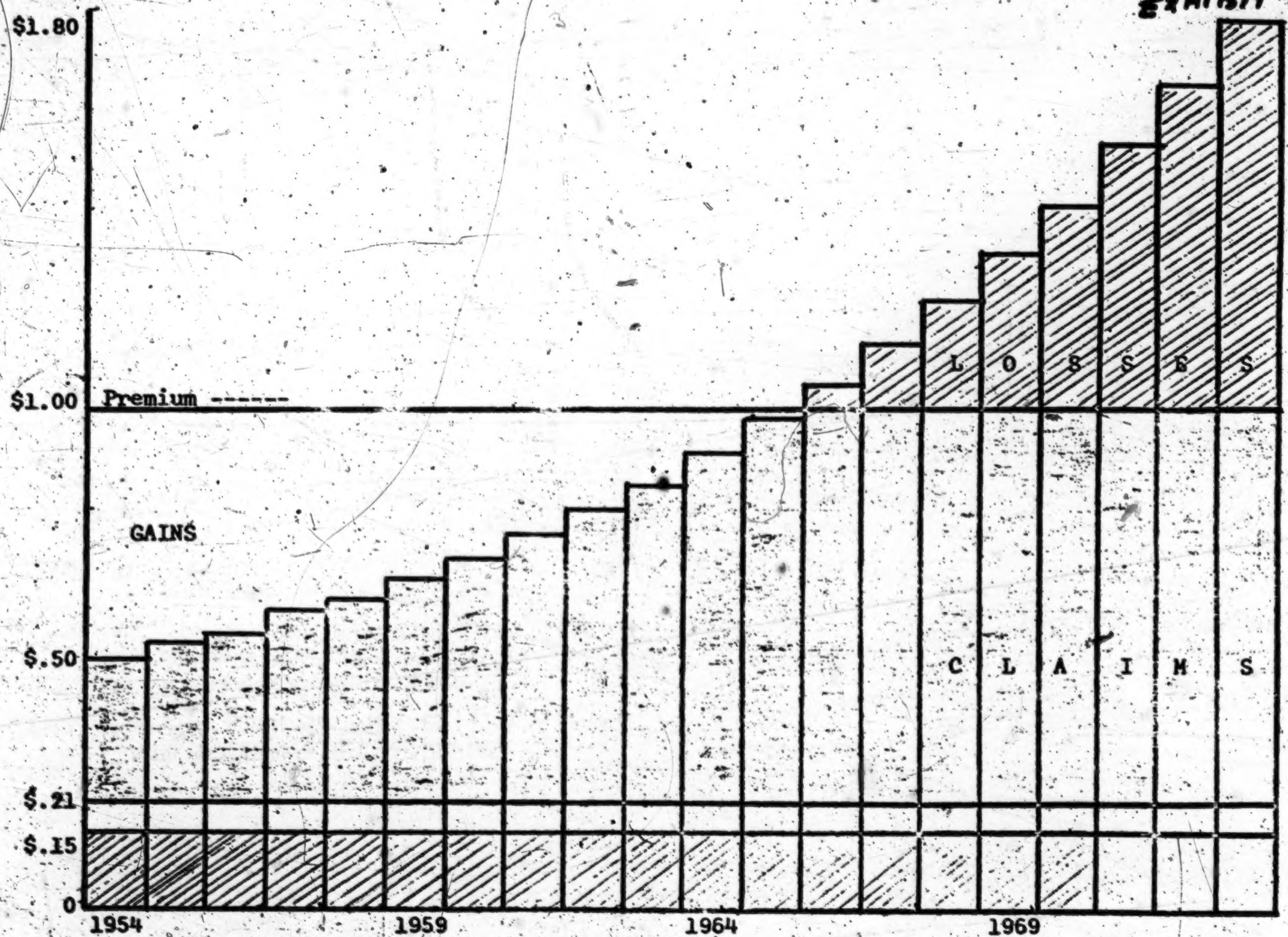
Mutual Savings Life, Missouri	637,667	1.57
National Bankers Life	949,958	1.05
National Educators Life	530,016	1.89
National Farmers Union Life	752,367	1.33
National Home Life Assurance	1,169,547	.86
National Life of America	1,591,422	.63
National Life & Casualty	857,679	1.17
National Public Service	1,027,432	.97
Northeastern Life of New York	838,802	1.19
Northwestern Life	668,262	1.50
Old American Insurance	3,150,535	.32
		AVERAGE
	80,176,308	.62

PETITIONERS' EXHIBIT 62
FIRST SECURITY LIFE INSURANCE COMPANY

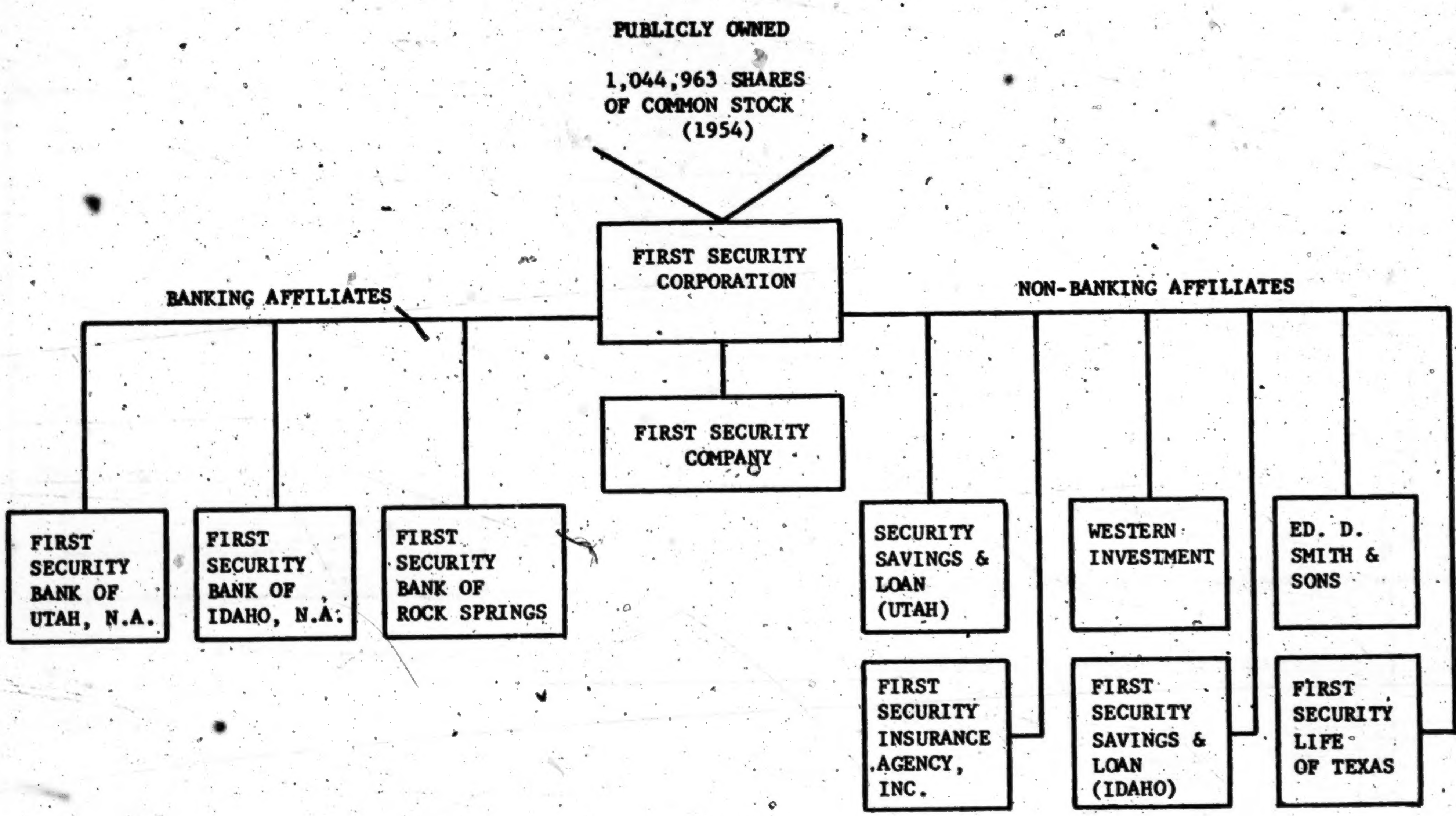
Maximum Retention Expressed as a Percentage of Capital and Surplus as of the Following December 31

Year	Capital and Surplus	Maximum Retention	Percentage
1954	$ 51,100.75	$ 5,000	9.8
1955	161,860.47	5,000	3.2
1956	377,998.81	10,000	2.6
1957	597,877.15	10,000	1.7
1958	1,063,961.53	10,000	.9
1959	816,941.15	10,000	1.2

EXHIBIT 63

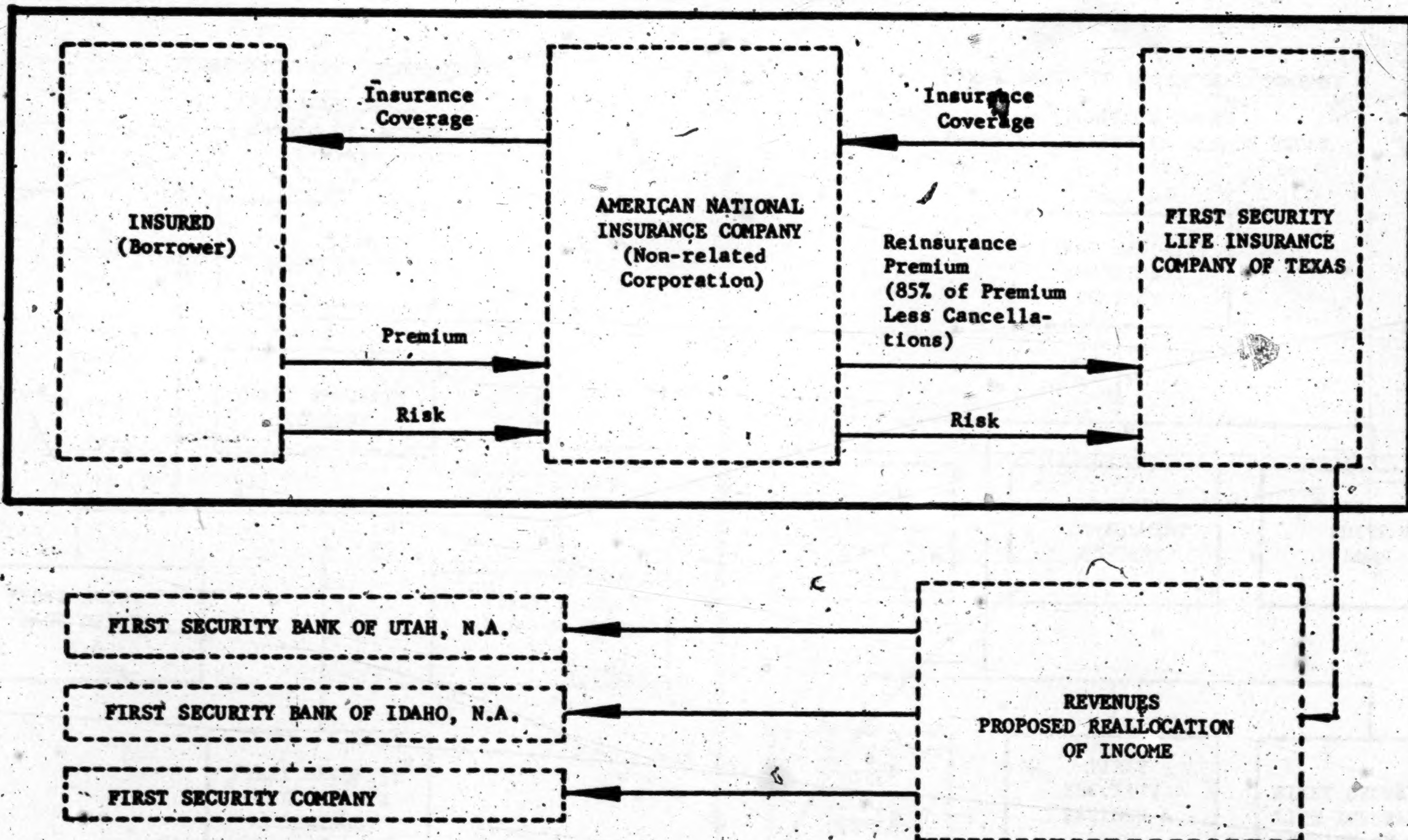


FIRST SECURITY LIFE INSURANCE COMPANY
INCREASING CLAIMS DUE TO
AGING
Age 45 Entry
(Based on 1958 CSO Table of Mortality)



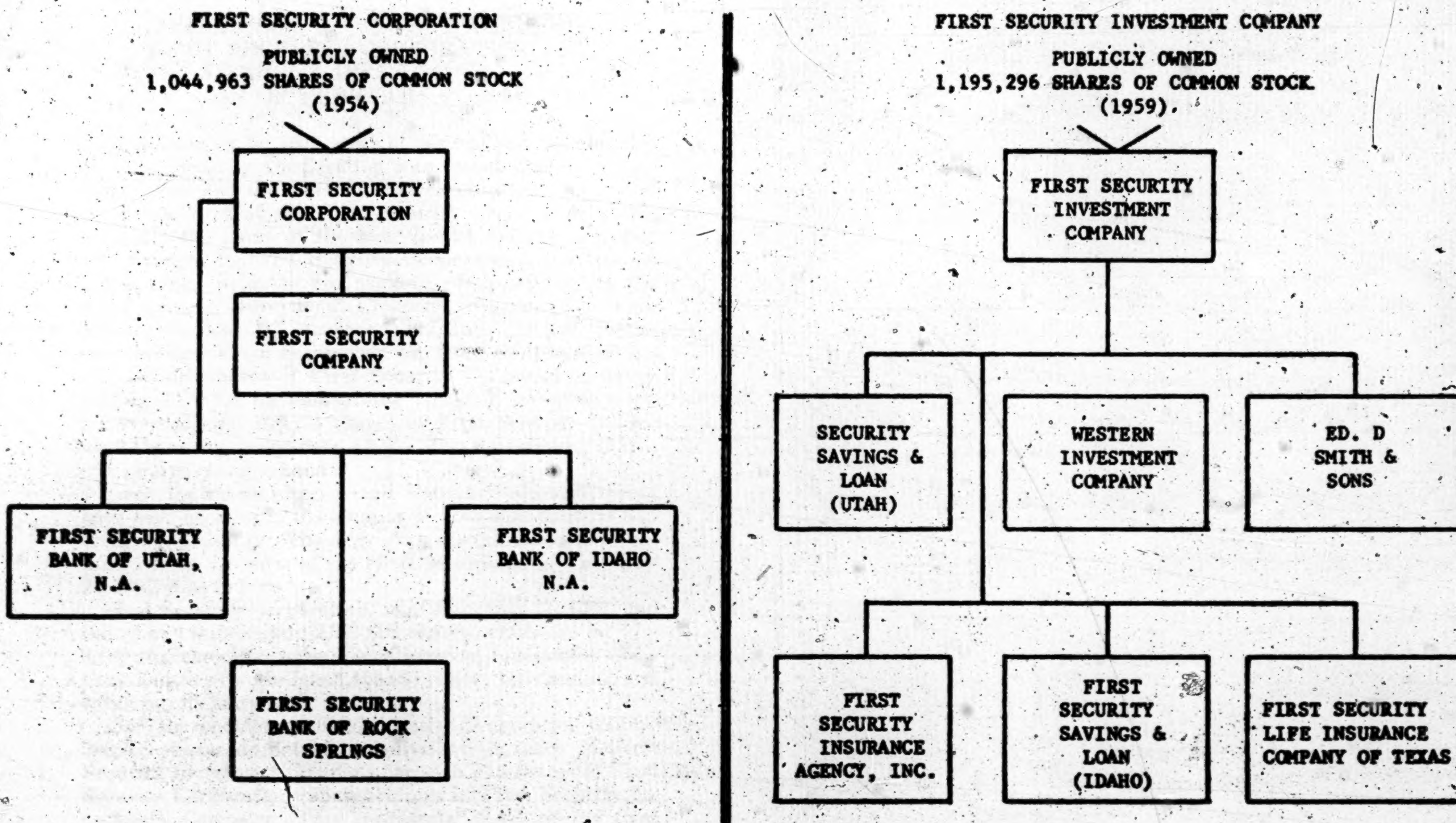
PETITIONERS' EXHIBIT 66

BUSINESS TRANSACTION IN QUESTION



PETITIONERS' EXHIBIT 67

AFTER REORGANIZATION IN 1959
TO COMPLY WITH THE BANK HOLDING COMPANY ACT OF 1956



PETITIONERS' EXHIBIT 68

JOINT EXHIBIT CH-51

COMPARISON OF STOCK OWNERSHIP FIRST SECURITY CORPORATION AND FIRST SECURITY INVESTMENT COMPANY AS OF FEBRUARY 21, 1967

On September 15, 1959, stock of various banking affiliates of First Security Corporation was transferred to a new corporation and the stock of that corporation was issued to shareholders of the First Security Corporation. Concurrently the name of the new (bank) holding company was changed to First Security Corporation, and the old corporation (with the non-banking affiliates) became the First Security Investment Company. At that time each corporation had 3,572 shareholders and 1,185,296 shares outstanding. From September 15, 1959, to December 31, 1959, 85,401 shares of First Security Corporation, representing 7.2% of its outstanding stock of 1,185,296, were transferred, and 105,174 shares of First Security Investment Company, representing 8.9% of its outstanding shares of 1,185,296 changed hands.

Since the reorganization and February 21, 1967, there have been changes in the identity of such shareholders and their stockholdings. The aggregate of such changes as obtained from a review of the stock records as of February 21, 1967, is as follows.

First Security Corporation, as of February 21, 1967, had issued and outstanding 2,591,692 shares, which are held by 5,488 shareholders, while First Security Investment Company had as of such date 1,105,685 shares outstanding and 4,086 shareholders.*

2,656 shareholders of First Security Corporation holding 995,768 shares do not have equivalent (1 share of First Security Investment Company for each 2.12 shares of First Security Corporation) shareholdings in First Security Investment Company. This represents 38.4% of the total outstanding shares and 48.4% of the number of share-

* The stock of First Security Corporation was split two for one and there have been three 2% stock dividends during the period from December 31, 1959, to February 17, 1967, so that for every share of First Security Investment Company, there are 2.12 shares of First Security Corporation.

holders whose interests in the two corporations are not the same.

1,257 shareholders of First Security Investment Company are holding 328,744 shares which are not represented by equivalent holdings in the First Security Corporation. This represents 29.7% of the total voting shares outstanding and 30.8% of the total shareholders whose interests in the two corporations are not the same.

TAX COURT OF THE UNITED STATES

T.C. Memo. 1967–256

[*Caption Omitted*] [1]

Filed December 27, 1967

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, *Judge:* Respondent determined deficiencies in the petitioners' income taxes as follows:

Docket No.	Petitioner	Taxable year	Deficiency
1190-63	First Security Bank of Utah, N.A.	1954	$ 68,250.00
		1955	28,775.81
		1956	54,526.56
		1957	77,862.91
		1958	159,371.46
		1959	109,166.60
1191-63	First Security Company	1956	95,997.48
		1957	126,400.83
		1958	262,124.10
		1959	179,550.34
1216-63	First Security Bank of Idaho, N.A.	1954	68,250.00
		1955	26,139.85
		1957	160,392.56
		1958	102,752.67

During the trial, respondent stated that he would not pursue one of the issues raised in the pleadings. We therefore conclude that he has abandoned it. The issues remaining for decision are:

(1) Whether respondent erred in allocating, pursuant to sections 61 and 482,[2] to petitioners First Security Bank of Utah, N.A., and First Security Bank of Idaho, N.A., a portion of the income which First Security Life Insurance Company of Texas received from January 1, 1955, to December 31, 1959, for reinsuring credit life, health, and acci-

[1] Proceedings of the following petitioners are consolidated herewith: First Security Company, Docket No. 1191-63, and First Security Bank of Idaho, N.A., Docket No. 1216-63.

[2] All statutory references are to the Internal Revenue Code of 1954, unless otherwise specified.

dent insurance,[3] or in the alternative, whether he erred in allocating, pursuant to said sections, to petitioner First Security Company a portion of said income which First Security Life Insurance Company of Texas received from January 1, 1956, to December 31, 1959; and

(2) whether respondent properly put section 482 in issue and, if so, whether he should have the burden of proof.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.

Petitioner First Security Bank of Utah, N.A. (hereinafter referred to as Utah Bank), is a national bank incorporated in 1882. It filed its Federal income tax returns for the taxable years involved herein on a calendar year basis with the district director of internal revenue, Salt Lake City, Utah. Its principal place of business was Salt Lake City, Utah, when it filed its petition in this case.

Petitioner First Security Bank of Idaho, N.A. (hereinafter referred to as Idaho Bank), is a national bank, incorporated as such in 1941 after operating since 1865 as a state bank. It filed its Federal income tax returns for the taxable years involved herein on a calendar year basis with the district director of internal revenue, Boise, Idaho. Its principal place of business was Boise, Idaho, when it filed its petition in this case.

Petitioner First Security Company (hereinafter referred to as Management Company) is a corporation organized under the laws of Utah in 1929. It filed its Federal income tax returns for the taxable years involved herein on a calendar year basis with the district director of internal revenue, Salt Lake City, Utah. Its principal place of business was Salt Lake City, Utah, when it filed its petition in this case.

Petitioners are wholly-owned subsidiaries of the First Security Corporation (hereinafter referred to as Holding

---

[3] The statutory notice received by petitioner First Security Bank of Idaho, N.A., contained adjustments to certain net operating loss carrybacks. Because of these adjustments, this Court has jurisdiction under section 6214(b) to determine the correctness of respondent's allocations to this petitioner for the years 1956 and 1959.

Company). It is the oldest bank holding company in existence. It is under the supervision and control of, and is regularly examined by, the Federal Reserve System. It is qualified under and subject to the Bank Holding Company Act, 12 U.S.C. sections 1841 *et seq*. From 1954 through September 15, 1959, Holding Company had approximately 1,044,963 shares of common voting stock outstanding and from 2,000 to 3,000 shareholders residing in various states and foreign countries.

Holding Company has had a policy of business expansion and acquisition throughout its existence. The banking offices of its subsidiaries extend from the Canadian border to the Arizona border. Moreover, it has entered into diversified enterprises other than banking.

From 1954 to September 15, 1959, Holding Company had the following wholly-owned subsidiaries, in addition to petitioners:

(a) The First Security Life Insurance Company of Texas (hereinafter referred to as Security Life), a corporation organized and licensed as an insurance company pursuant to the laws of Texas.

(b) Ed. D. Smith and Sons (hereinafter referred to as Smith), a Utah corporation. It had approximately twenty employees and sold life and casualty insurance. It had a yearly premium volume of approximately $800,000.

(c) First Security Insurance Agency, Inc. (hereinafter referred to as Agency), an Idaho corporation. It sold insurance and had a yearly premium volume of about $175,000.

(d) Western Investment Corporation, an Idaho corporation holding various assets.

(e) First Security State Bank, a Utah State bank.

(f) First Security Bank, a Wyoming State bank.

(g) Security Savings and Loan Association, a Utah State savings and loan association; and

(h) First Security Savings and Loan Association, an Idaho State savings and loan association.

On September 15, 1959, Holding Company underwent a reorganization pursuant to the Bank Holding Company Act, *supra*. The banking subsidiaries, including the three petitioners herein, were placed in a newly-organized bank holding company. The shareholders of Holding Company received the stock of the new bank holding company. The

nonbanking subsidiaries, excluding Security Life, remained in the old holding company.[4]

Utah Bank and Idaho Bank have numerous banking offices. Both are subject to supervision, inspection, and control by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency and are regularly examined by them. The articles of incorporation of the banks limit them to the business of banking under the laws of the United States. Under the national banking laws, the members of the boards of directors of the banks are responsible for the proper operation of the banks. During the years in issue, Utah Bank had 141,000 to 192,000 depositors and $217,000,000 to $292,000,000 in deposits. During the same years, Idaho Bank had 113,000 to 131,000 depositors and $183,000,000 to $205,000,000 in deposits.

Management Company provides accounting and other management services to the other subsidiaries of Holding Company. Management Company is subject to control, supervision, and inspection by the Board of Governors of the Federal Reserve System and is regularly examined by it.

In 1948 Utah Bank and Idaho Bank began making available credit life, health, and accident insurance (hereinafter referred to as credit insurance)[5] to their customers. They did this for several reasons, including (1) to offer a service increasingly supplied by competing financial institutions, (2) to obtain the benefits of the additional collateral which credit insurance provides by repaying loans upon the death, injury, or illness of the borrower, and (3) to provide an additional source of income—part of the premiums from the insurance—to Holding Company or its subsidiaries.

From 1948 through 1952, Credit Life Insurance Company of Springfield, Ohio, wrote the credit insurance which Utah Bank and Idaho Bank had available for their customers. Credit Life Insurance Company and Smith entered into

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[4] Although the new holding company received the name of the old one—First Security Corporation—while the old one changed its name to First Security Investment Company, the term "Holding Company" will continue to refer to the pre-reorganization holding company.

[5] For a description of the credit insurance industry, see *Local Finance Corporation*, 48 T.C. 773 (1967), at 776 *et seq.*

agency agreements designating Smith as Credit Life's agent in writing the the insurance. Pursuant to the agreements, Credit Life paid commissions to Smith as follows:

Period	Amount of payment to Smith per agency agreement	Characterization of payment in agency agreement
9-24-48 through 6-1-50.	40 to 50 percent of net premiums collected, based on volume.	Commissions.
6-1-50 through 12-31-52.	55 percent of premiums	45 percent commission, 10 percent expense reimbursement.

From January 1, 1953, through April 1, 1954, American Bankers Life Assurance Company of Florida wrote the credit insurance which Utah Bank and Idaho Bank had available for their customers. American Bankers Life Assurance Company and Smith entered into an agency agreement designating Smith as American Bankers' agent in writing the insurance. Pursuant to the agreement, American Bankers paid commissions to Smith of 55 percent of the net premiums collected on life insurance and 50 percent of the net premiums collected on health and accident insurance.

Late in 1953, American National Insurance Company of Galveston, Texas (hereinafter referred to as National),[6] approached Holding Company with a plan whereby National would write the credit insurance which Utah Bank and Idaho Bank made available to their customers. The plan called for Holding Company to create a life insurance subsidiary. The subsidiary's business would be to reinsure the risks of the credit insurance policies written by National for the customers of the two Banks. Profits from the business could be retained in the subsidiary for investment. In its initial years, the subsidiary would utilize National's established and experienced operating services—actuarial, accounting, etc.—on a fee basis. If the plan proved successful, the new insurance subsidiary could grow into a full-line, direct-writing insurance company.

Holding Company was one of many financial institutions which National approached with such a plan. During 1953 National concluded that lending institutions would soon

[6] National is a leading nationwide insurance company. It is independent of and unrelated to Holding Company and its subsidiaries.

begin to form their own life insurance companies to write the credit insurance which they made available to their customers. They based their conclusion upon the facts that writing credit insurance was proving to be a very profitable business and that there were considerable tax savings on premium income.[7] This potential move by lending institutions would ultimately deprive National and other independent insurance companies of their credit insurance business. To salvage what it could from the situation, National decided to encourage lending institutions to develop their own life insurance companies by utilizing the operating services which National had developed for writing credit insurance. By charging a fee for the services, National would recoup something from its investment in the credit insurance business.

Holding Company decided to adopt National's plan. It did so for numerous reasons, including its policy of business expansion. To implement the decision, Holding Company incorporated Security Life in June 1954. Security Life was incorporated under the laws of Texas and approved by the Texas State Board of Insurance Commissioners. It had an initial capital of $25,000[8] and an initial paid-in surplus of $12,500.[9]

National began writing credit insurance for the customers of Utah Bank and Idaho Bank in April 1954. The insurance was reinsured with Security Life under contracts called reinsurance treaties. Under the treaties National received approximately 15 percent of the premium dollar for its managerial services and Security Life received the balance of the premium dollar for its assumption of 100 percent of the risk under the insurance policies.[10]

From April 1954 through 1959, National maintained Security Life's books and records and computed its re-

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[7] The Life Insurance Company Income Tax Act of 1959 in large part eliminated the tax savings. See generally Mertens, sec. 44A.01 *et seq.*

[8] Security Life's capital was increased to $100,000 in 1956 through a $75,000 stock dividend.

[9] This was an unusually low capitalization with which to begin an insurance company. In 1954 Texas had low minimum capitalization requirements for incorporating insurance companies.

[10] The maximum on one life under the policies which Security Life reinsured was $5,000.

quired reserves. By purchasing the services of National, Holding Company effected considerable savings over what would have been the case had it attempted to launch a full-line, direct-writing company from the outset. It is a common practice to begin an insurance company by reinsuring risks and, if successful, grow into a full-line, direct-writing company.[11] There is no basic actuarial or business difference between an insurance company which reinsures and a direct-writing company.

Utah Bank and Idaho Bank had a routine procedure for making credit insurance available to customers. A loan officer explained the availability and function of credit insurance to a customer. If the customer desired the insurance, the loan officer gave him application forms. The customer then filled in the application. After examining the application, Bank personnel filled in a certificate of insurance and either collected the premium from the customer or added it to his loan. As the final step, Bank personnel forwarded the completed forms to Management Company for further handling.

Utah Bank and Idaho Bank did not require customers to purchase credit insurance. During the years in issue, less than one-half of the Banks' installment loan customers elected to take insurance and less than 13 percent of the Banks' real estate loan customers elected to take insurance.

The cost to Utah Bank and Idaho Bank of processing the insurance was negligible. For the five years in issue, the total cost to Utah Bank was $8,929.30 and the total cost to Idaho Bank was $9,826.43.[12]

Management Company's role in processing the credit insurance was in the nature of bookkeeping. It had no contact with the public with respect to writing credit insurance. It received the forms, duplicate certificates, and premiums from Utah Bank and Idaho Bank. It then made records of insurance purchased and forwarded premiums to National. It also did the paper work when claims had to be filed under the policies.

The cost to Management Company of processing the

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[11] Security Life never developed into a full-line, direct-writing company.

[12] These figures are derived from an extensive time-cost study prepared by an employee of Management Company.

insurance was negligible. For the five years in issue, the total cost was $10,150.34.[13]

Idaho Bank, Utah Bank, and Management Company were not parties to the legal relationships and obligations of the insurance policies. National wrote the insurance and the Banks' customers were its policyholders. Under the terms of the policies, National was responsible for payment of claims. Under the reinsurance treaties, Security Life was obligated to reimburse National for claims it paid.

Other than group policies, there were no contracts, agency agreements, or other legal connections between National and Idaho Bank, Utah Bank, or the employees of both. There were no contracts, agency agreements, or other legal connections between National and Management Company or its employees.

From 1948 through 1959, the credit insurance which Idaho Bank and Utah Bank made available to their customers was priced at the uniform rate of $1 per $100 coverage per year on a decreasing term basis. This was the rate commonly charged in the industry. It was accepted by the insurance commissioners of the states involved herein —Utah, Idaho, and Texas.

During the years in issue, Security Life paid state and Federal taxes, used its own stationery, made deposits and withdrawals from bank accounts in its own name, and invested in its own name. Its sole source of business income was reinsurance premiums. Its business expenses were primarily bank charges, taxes, and claims settlement expenses.

Security Life's credit insurance business was very profitable. Its yearly operations for the period 1955 through 1959 are reflected in the following table:

Year	Net premium [1]	National's fee	Reinsurance premium received by Security Life	Claims and claims expenses	Net profit to Security Life
1955	$145,927.55	$24,765.65	$121,161.90	$45,340.38	$75,821.52
1956	277,437.45	43,695.72	233,741.73	97,609.66	136,132.07
1957	367,612.62	55,590.64	312,021.98	114,014.49	198,007.49
1958 [2]	647,874.90	62,954.22	584,920.68	118,874.46	466,046.22
1959	477,389.43	71,608.43	405,781.00	149,948.92	255,832.08
Total	$1,916,241.95	$258,614.66	$1,657,627.29	$525,787.91	$1,131,839.38
Less closing Life Reserve, 12–31–59					110,806.00
Less general expense for period 1–1–55 through 12–31–55					16,339.00
Total profit					$1,004,694.38

[1] Gross premium less cancellations and adjustments.
[2] Includes 1958 reserve adjustment.

[13] This figure is derived from the time-cost study described in footnote 12, *supra*.

Security Life's operations for the years in issue are summarized in the following table in terms of percentages of total net premiums received.

Item:	*Percent of total net premiums received*
Fee paid to National	13.5
Claims paid	27.4
Life reserve on 12/31/59 and general expenses	6.6
Balance	52.5
Total	100.0

Security Life's balance sheets for the period January 1, 1955, through December 31, 1959, are summarized in the following table:

	1955	1956	1957	1958	1959
Assets	$161,370.52	$390,286.87	$648,586.43	$1,204,424.45	$1,050,220.71
Liabilities (including reserves)	13,076.98	22,295.00	30,277.60	271,479.06	197,687.00
Capital	25,000.00	100,000.00	100,000.00	100,000.00	100,000.00
Surplus:					
Paid-in	12,500.00	12,500.00	12,500.00	12,500.00	12,500.00
Unassigned		35,099.41			
Earned	110,793.54	220,392.46	505,808.83	820,445.39	[1] 740,033.71
	$161,370.52	$390,286.87	$648,586.43	$1,204,424.45	$1,050,220.71

[1] Security Life paid a dividend of $389,821.61 to Holding Company during 1959.

Although Security Life's business proved to be successful, there was no way to judge at the outset whether it would succeed. In relation to its capital structure, Security Life reinsured a large amount of risk. The following table shows the number of policies reinsured, the amount of risk it assumed, and the number of extra maximum claims which would have eliminated its surplus at the end of a year:

Year	Number of policies	Amount of risk at end of year	Number of extra maximum claims which would have eliminated surplus
1954	12,500	$ 6,483,000	3
1955	27,594	13,360,000	9
1956	34,388	21,105,000	28
1957	29,591	25,570,000	28
1958	32,155	36,761,000	50
1959	36,416	41,350,000	97

Furthermore, there were several aspects of Security Life's business which could have invited high mortality rates. Customers of the two Banks could obtain credit insurance without a health examination and there was no waiting period before the insurance went into effect. In addition, Security Life was a relatively small insurance company and its policyholders lived in a relatively limited geographical area.

Since Utah Bank and Idaho Bank began making available credit insurance to their customers in 1948, the officers of Holding Company and of the two Banks have held the belief that it would be contrary to Federal banking law for the two Banks to receive income resulting from their customers' purchase of credit insurance. They based the belief on the advice of legal counsel. Pursuant to the belief, the two Banks have never received or attempted to receive commissions or reinsurance premiums resulting from their customers' purchase of credit insurance.

Petitioners Idaho Bank and Utah Bank reported no income from sales of credit insurance on their Federal income tax returns for the years 1955 through 1959. Petitioner Management Company reported no income from sales of credit insurance on its Federal income tax returns for the years 1956 through 1959.

In his statutory notices of deficiency, respondent allocated to petitioners Utah Bank and Idaho Bank the reinsurance premiums received by Security Life from 1955 through 1959. He also, alternatively, allocated to petitioner Management Company the reinsurance premiums received by Security Life from 1956 through 1959.[14] The pertinent explanatory material in each notice of deficiency is as follows:

> It is determined that the insurance premium[s] and/or commission income reported as income by the First Security Life Insurance Company of Texas, a corporation, the stock of which is owned by The First

[14] During the trial and on brief, respondent only urged the allocation of 40 percent of the net premiums which Security Life received from reinsuring credit insurance. He did not allocate any income which Security Life received for reinsuring risks on mortgage, twin-dollar, and borrow-by-check insurance, three types of insurance which Security Life reinsured in addition to what we refer to herein as credit insurance.

Security Corporation, the same corporation which owns your stock, should have been reported by you. Therefore, your taxable income is increased as indicated for each of the taxable years 1955 [1956] through 1959.

In a different case than the one at bar, respondent has asserted a deficiency against Security Life for the years 1955 through 1959. More than three years before the trial of the present case, Security Life filed a sworn protest with the district director of internal revenue, Salt Lake City, Utah, contesting the asserted deficiency. Counsel for petitioners herein prepared Security Life's protest. To explain the difference between Security Life's case and the case at bar, the protest contains the following language:

> The issues involved are not at all related; each turns on its own set of facts and its own section of the Internal Revenue Code. The issue involved in the bank cases is whether the banks were the true earners of the income, and hence taxable under Section 482. The issue in this case is whether the reserves were established and maintained on an actuarial basis as required by Section 801(a).

In the case at bar, respondent never filed any document prior to the pretrial conference formally notifying petitioners that he intended to rely on section 482. Two days prior to the trial herein, respondent filed a motion for a pretrial conference pursuant to Rule 28, Rules of Practice of the Tax Court. In the motion, respondent stated that he would rely on section 482 as well as section 61.

OPINION

The first issue is whether respondent has properly put section 482 in issue.

Petitioners argue that because respondent did not specifically mention section 482 in his notices of deficiency, and because he did not otherwise specifically and formally notify petitioners prior to the pretrial conference that he would rely on section 482, he is barred from relying on that section. Alternatively, petitioners argue that if we permit respondent to rely on section 482, he should bear the burden of proof because the determination with respect

to the section 482 issue in the statutory notices does not contain sufficient legal and factual grounds.

We do not agree with either argument. Petitioner's counsel knew three years in advance of the trial that respondent would rely on section 482. Moreover, petitioners do not allege surprise or suggest that they were prejudiced in any way by respondent's alleged omissions. It is clear from the record that petitioners' counsel were well prepared with an extensive and thorough case on the section 482 issue. In view of these circumstances, the cases which petitioners cite on this point are distinguishable. We hold that respondent has properly put section 482 in issue and that petitioners have the burden of proof.

The second issue is whether respondent erred in allocating, pursuant to sections 61 and 482, either to Utah Bank and Idaho Bank or to Management Company 40 percent of the net premiums which Security Life received during the years in issue for reinsuring credit insurance.

In all essential respects, the facts of the case at bar are the same as those in *Local Finance Corporation*, 48 T.C. 773 (1967). Because of our decision in that case, most of petitioners' arguments on this issue are untenable. Petitioners do, however, make two arguments concerning the actuarial soundness of respondent's allocations which are not foreclosed by our earlier decision.[15]

Petitioners' main actuarial argument is based upon the testimony of their expert actuary. The crux of the testimony is the opinion contained in the following exchange:

> Q. What is your opinion?
>
> A. The size and nature of the risk assumed by this company [Security Life] in relationship to its capital structure required it to retain every dollar that it could possibly do so.
>
> Q. To stay on an actuarially sound basis?
>
> A. Yes.

Petitioners' actuary based his opinion upon the amount of risk which Security Life reinsured and upon factors in its insurance operation which might have invited high mortality rates.

Petitioners claim that their actuarial evidence demonstrates that Security Life would have been actuarially

[15] See *Local Finance Corporation*, *supra*, at 791.

unsound if it had paid an insurance commission to the Banks equal to what respondent now allocates to them. It follows, petitioners argue, that respondent's allocation pursuant to sections 61 and 482 is unreasonable.

We do not agree. The central fact upon which petitioners' actuary based his testimony was Security Life's initial capital structure of $37,500. In the above-quoted passage he said that Security Life assumed great risk "in relationship to its capital structure." Respondent's actuary pointed out that Security Life's initial capitalization was unusually low for an insurance company. Petitioners' actuary corroborated this with the following testimony:

> Now, within the life insurance industry there is a very much used rule of thumb for new life insurance companies that is to establish it with capital and surplus of approximately 100 times its maximum risk on one life.
>
> This is arbitrary and a rule of thumb, but it is also true that throughout the industry the amount that companies will retain on one life is closely in that neighborhood.

The maximum risk on one life under the policies reinsured by Security Life was $5,000. Using the formula suggested by petitioners' actuary, Security Life's initial capitalization should have been $500,000, not $37,500. If its initial capitalization had been $500,000 rather than $37,500, petitioners' actuarial evidence would be meaningless. The validity of the evidence, in other words, hinges upon the fact that Security Life began business as an undercapitalized insurance company. This evidence does not persuade us that respondent's allocation pursuant to sections 61 and 482 is unreasonable.

Petitioners make another actuarial argument based upon the fact that respondent, during trial and on brief, did not allocate to them Security Life's income from reinsuring risks on lines of insurance other than what we herein refer to as credit insurance. Petitioners contend that respondent ignored these lines because Security Life had a much higher claims experience with them than with credit insurance. Petitioners argue that this omission by respondent is a concession that a 40 percent allocation on the other lines of insurance would be unreasonable. They conclude that

what is unreasonable for the other lines of insurance is also unreasonable for credit insurance.

We do not agree. Petitioners did not attempt to prove any business or actuarial similarities between Security Life's reinsurance of credit insurance and its reinsurance of other lines. It follows that we cannot draw inferences between the two lines. We do not decide what meaning, if any, attaches to the fact that respondent did not allocate Security Life's income from reinsuring the other lines of insurance.

Neither of petitioners' actuarial arguments persuades us that respondent's allocation pursuant to sections 61 and 482 is unreasonable. The arguments do not, therefore, distinguish the present case from *Local Finance Corporation, supra.* It follows that we must uphold as reasonable respondent's allocation of part of Security Life's income.

One problem remains—to which taxpayer should we allocate the income in question. Respondent, in his notices of deficiency, allocates the income either to Utah Bank and Idaho Bank or to Management Company.

Petitioners argue that the only taxpayers to which we can properly allocate the income are Smith and Agency, neither of which is a party herein. Their theory is based upon the facts that from 1948 through 1954 insurance commissioners for the sale of credit insurance in the two Banks were payable to Smith and that during the years here in issue Smith and Agency held licenses to sell insurance. Because insurance commissions have never been payable to petitioners, and because none of the petitioners has ever held a license to sell insurance, they argue that it is logical to allocate the income to Smith and Agency, rather than to them.

We do not agree. Petitioners performed services with regard to the sale of credit insurance during the years in issue. Smith and Agency did not. Therefore, it is not proper to allocate the income to Smith and Agency. See concurring opinion in *Local Finance Corporation, supra,* at 797.

Among the petitioners, we allocate the income to Utah Bank and Idaho Bank. Our decision in *Local Finance Corporation* dictates this result.

Decisions will be entered under Rule 50.

TAX COURT OF THE UNITED STATES

Docket No. 1190-63

[*Caption Omitted*]

DECISION

(Entered May 7, 1969)

Pursuant to the opinion of the Court filed December 27, 1967, and incorporating herein the facts recited in the respondent's computation as the findings of the court, it is

Ordered and Decided: That there are deficiencies in income taxes due from the petitioner as follows:

Year	Deficiency
1954	$ None
1955	13,810.59
1956	24,900.55
1957	35,777.24
1958	64,670.35
1959	48,705.19

/s/ Wm. M. Fay

(Seal) *Judge*

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

Alonzo W. Watson, Jr.
Counsel for Petitioner.

Richard M. Hahn,
Acting Chief Counsel,
Internal Revenue Service.

TAX COURT OF THE UNITED STATES

Docket No. 1191-63

[*Caption Omitted*]

DECISION

(Entered May 7, 1969)

Pursuant to the opinion of the Court filed December 27, 1967, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

Ordered and Decided: That there are no deficiencies in income taxes due from, or over-payments due to, the petitioner for the taxable years 1956, 1957, 1958 and 1959.

Wm. M. Fay
Judge

(Seal)

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

Alonzo W. Watson, Jr.
Counsel for Petitioner.

Richard M. Hahn,
Acting Chief Counsel,
Internal Revenue Service.

TAX COURT OF THE UNITED STATES

Docket No. 1216-63

[*Caption Omitted*]

DECISION

(Entered May 7, 1969)

Pursuant to the opinion of the Court filed December 27, 1967, and incorporating herein the facts recited in the re-

spondent's computation as the findings of the Court, it is

Ordered and Decided: That there is no deficiency in income tax due from, or overpayment due to, the petitioner for the taxable year 1954; and

That there are deficiencies in income taxes due from the petitioner for the taxable years 1955, 1957 and 1958 in the amounts of $16,542.34, $124,084.44 and $70,087.63, respectively.

Wm. M. Fay
Judge

(Seal)

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein.

Alonzo W. Watson, Jr.
Counsel for Petitioner.

Richard M. Hahn,
Acting Chief Counsel,
Internal Revenue Service.

TAX COURT OF THE UNITED STATES

Docket No. 1190-63

[*Caption Omitted*]

Notice Of Appeal

Notice is hereby given that First Security Bank of Utah, N.A., hereby appeals to the United States Court of Appeals for the 10th Circuit from the decision of the Court entered in the above captioned proceeding on the 7th day of May, 1969, relating to the reallocation of income from the First Security Life Insurance Company of Texas to the First Security Bank of Utah, N.A., the burden of proof and reliance on Section 482 of the Internal Revenue Code, and from the order of the Court denying petitioner's motion

to alter and amend findings and for a reconsideration, which order was entered March 19, 1968.

Dated this 23rd day of July, 1969.

Ray, Quinney & Nebeker
By Alonzo W. Watson, Jr.
Attorneys for Petitioner-Appellant
First Security Bank of Utah, N.A.

Stamp
Tax Court Mail Room
1969 Jul 28 AM 8 34
Filed July 28, 1969.

Tax Court of the United States, Washington, D. C.

Docket No. 1191-63

[*Caption Omitted*]

Notice Of Appeal

Notice is hereby given that the Commissioner of Internal Revenue appeals to the United States Court of Appeals for the Tenth Circuit from the decision of this Court entered in the above-captioned proceedings on the 7th day of May, 1969, wherein the Court ordered and decided that there were no deficiencies in income tax due from petitioner for its taxable years 1956, 1957, 1958 and 1959.

On the date that taxpayer filed its petition with the Tax Court of the United States, its principal place of business was located in Salt Lake City, Utah thereby establishing venue in the United States Court of Appeals for the Tenth Circuit.

Johnnie M. Walters
Assistant Attorney General
Department of Justice
K. Martin Worthy, *Chief Counsel*
Internal Revenue Service
Counsel for Appellant on Review

Of Counsel:
Bobby D. Burns
Attorney
Internal Revenue Service
Filed August 4, 1969.

TAX COURT OF THE UNITED STATES

Docket No. 1216-63

[*Caption Omitted*]

Notice Of Appeal

Notice is hereby given that First Security Bank of Idaho, N.A., hereby appeals to the United States Court of Appeals for the 10th Circuit from the decision of the Court entered in the above captioned proceeding on the 7th day of May, 1969, relating to the reallocation of income from the First Security Life Insurance Company of Texas to the First Security Bank of Idaho, N.A., the burden of proof and reliance on Section 482 of the Internal Revenue Code, and from the order of the Court denying petitioner's motion to alter and amend findings and for a reconsideration, which order was entered March 19, 1968.

Dated this 29th day of July, 1969.

Stamp
Tax Court Mail Room
1969 Jul 31 AM 8 36

Ray, Quinney & Nebeker
By Alonzo W. Watson, Jr.
Attorneys for Petitioner-Appellant
First Security Bank of Idaho, N.A.

Filed July 31, 1969.

United States Court of Appeals, Tenth Circuit

January Term, 1971

[*Captions Omitted*]

APPEALS FROM DECISIONS OF THE TAX COURT OF THE UNITED STATES

Before BREITENSTEIN and SETH, Circuit Judges, and TEMPLAR, District Judge.

BREITENSTEIN, Circuit Judge.

These consolidated appeals from the Tax Court relate to the allocation of income among taxpayers. No. 611–69 is an appeal by First Security Bank of Utah, N.A., (Utah Bank) from the decision that for the years 1955 to 1959 inclusive there is a deficiency in income taxes due from the taxpayer in the amount of $187,863.92. No. 612–69 is an appeal by First Security Bank of Idaho, N.A., (Idaho Bank) from the holding that for the tax years 1955, 1957, and 1958 there is a deficiency of $210,714.41. No. 613–69 is a protective appeal by the Commissioner of Internal Revenue from the decision that there are no deficiencies in the income taxes due from First Security Company (Management Company) for the years 1956 to 1959 inclusive. The Tax Court held that approximately 40% of credit insurance net premiums paid by borrowers from the two banks, and reported by another corporation, were allocable to income of the banks. Jurisdiction is conferred by 26 U.S.C. § 7482 (a). Venue for the appeal of the Idaho Bank is in this court pursuant to a stipulation made under § 7482(b)(2). The findings of fact and opinion of the Tax Court are not officially reported but are found at 26 T.C.M. 1320.

The taxpayers are national banks. They and a Wyoming bank, Management Company, and certain nonbanking affiliates were until 1959 wholly owned subsidiaries of First Security Corporation, a bank holding company which is publicly owned. During the years in issue Utah Bank had 141,000 to 192,000 depositors and $217,000,000 to $292,000,000 in deposits and Idaho Bank had 113,000 to 131,000 depositors and $183,000,000 to $205,000,000 in deposits. Management Company provided accounting and other managerial services to subsidiaries of Holding Company.

Since 1948 the banks have made available to their bor-

rowers credit life, health, and accident insurance which pays off the debt in case the borrower dies or is incapacitated during the term of his loan. The Tax Court found that they did this "for several reasons, including (1) to offer a service increasingly supplied by competing financial institutions, (2) to obtain the benefits of the additional collateral which credit insurance provides by repaying loans upon the death, injury, or illness of the borrower, and (3) to provide an additional source of income—part of the premiums for the insurance—to Holding Company or its subsidiaries." The premium charge for the credit insurance was at the uniform rate of $1.00 per $100.00 of coverage per year on a decreasing term basis. This was the rate commonly charged in the industry and was accepted by the insurance commissioners of the states involved—Utah, Idaho, and Texas. The banks did not require their borrowers to purchase credit insurance. During the taxable years less than 50% of their installment loan customers and less than 13% of their real estate loan customers elected to take insurance.

The banks had a routine procedure for making credit insurance available to customers. A loan officer explained the function and availability of the insurance. If the customer desired the insurance, the loan officer gave him the application forms for completion. Bank personnel examined the application, made out a certificate of insurance, and either collected the premium from the customer or added it to his loan. There is no showing that any of the bank personnel were licensed insurance agents. As the final step, bank employees forwarded the completed forms and premiums to Management Company for further handling. Management Company's role in processing the credit insurance was in the nature of bookkeeping. It had no contact with the public in respect to the writing of credit insurance. It received the forms, duplicate certificates, and premiums from the banks, made records of the insurance purchased, and forwarded the premiums to the insurance carrier. It also did the paper work when claims were filed under the policies.

The following items show pertinent facts with regard to the credit insurance which concerns us.

1. The number of policies written and the amount of risk at the end of each year, 1954 to 1959, inclusive, varied from

a low of 12,500 and $6,483,000 respectively in 1954 to a high of 36,416 and $41,350,000 respectively in 1959.

2. The net premiums for the years 1955 to 1959 inclusive totalled $1,916,241.95.

3. The claims and claim expenses for the years 1955 to 1959 inclusive totalled $525,787.91.

4. For the years in issue the total cost to the Utah Bank for processing the insurance was $8,929.30, to the Idaho Bank $9,826.43, and to Management Company $10,150.34. The Tax Court described these costs as "negligible."

From 1948 to April 1, 1954, the credit insurance coverage on the banks' borrowers was carried first by Credit Life Insurance Company of Springfield, Ohio, and later by American Bankers Life Assurance Company of Florida; both of which were independent of Holding Company and its subsidiaries. Commissions varying from 40% to 55% of net premiums were paid to Ed. D. Smith & Sons which was an insurance agency and a wholly owned subsidiary of Holding Company.

American National Insurance Company of Galveston, Texas, an independent company, wrote a large volume of credit insurance. Foreseeing a change in the credit insurance business, National, late in 1953, approached Holding Company and other financial institutions with a plan whereby it would write credit insurance available to borrowers. The plan called for Holding Company to create a life insurance subsidiary. The subsidiary's business would be to reinsure the risks of the credit insurance policies written by National for the customers of Utah Bank and Idaho Bank. Profits from the business could be retained in the subsidiary for investment. In its initial years, the subsidiary would utilize National's established and experienced operating services, such as actuarial and accounting, on a fee basis. If the plan proved successful, the new subsidiary could grow into a full-line, direct-writing insurance company.

Holding Company adopted National's plan and in June, 1954, incorporated First Security Life Insurance Company of Texas under the laws of Texas with an initial capital of $25,000 and an initial paid-in surplus of $12,500. The credit insurance written by National for the two banks was reinsured with Security Life under contracts called reinsurance treaties. Thereunder National received approximately 15%

of the premium dollar for its technical services and Security Life received the balance for its assumption of 100% of the risks under the policies. The maximum risk on one life under the policies reinsured by Security Life was $5,000.

In 1956, Security Life's capital was increased to $100,000. During the period it did not become a full-line, direct-writing insurance company. Although Security Life's business proved successful, this result was not assured at the outset. In relation to its capital structure Security Life reinsured a large amount of risk. As noted by the Tax Court, several aspects of its business could have invited high mortality rates. Customers of the banks obtained credit insurance without a health examination and without a waiting period. Also, Security Life was a relatively small insurance company and its policyholders lived in a relatively limited geographical area.

During the years in issue, Security Life paid state and federal taxes, used its own stationery, made deposits and withdrawals from bank accounts in its own name, and reinvested in its own name. Its sole source of business income was from reinsurance premiums. Its business expenses were primarily bank charges, taxes, and claims settlements. It paid a dividend to Holding Company of $389,821.61 in 1959.

On September 15, 1959, as a result of a reorganization pursuant to the 1956 act regulating bank holding companies, see 12 U.S.C. § 1841 et seq., the Utah and Idaho banks became owned by First Security Corporation, a publicly held corporation, and Security Life became owned by First Security Investment Company, also a publicly held corporation. The parties have stipulated that as of February, 1967, there was a substantial difference in the ownership of the shares of the two companies.

On December 21, 1962, the Commissioner sent notices of deficiency to the taxpayers based on an allocation to the banks of approximately 47% of Security Life's premium income, during the years in issue, after payment of National's management fees. An alternative allocation was made to Management Company. On the authority of *Local Finance Corporation v. Commissioner of Internal Revenue*, 48 T.C. 773, affirmed, 7 Cir., 407 F. 2d 629, cert. denied 396 U.S. 956, the Tax Court upheld Commissioner's allocation of income to the banks and denied his alternative allocation

to Management Company. The banks have each appealed from the adverse decision on liability for tax deficiencies, and the Commissioner has taken a protective appeal from the conclusion of no deficiency due from Management Company.

Section 61 of the Internal Revenue Code of 1954, 26 U.S.C. § 61, defines gross income to mean all income from whatever source derived including, among specified items, "(1) Compensation for services, including fees, commissions, and similar items; (2) Gross income derived from business."

Section 482 of the Code, 26 U.S.C. § 482, covers allocations of income and deductions among taxpayers and provides that:

> In any case of two or more organizations * * * owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, * * * if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, * * *

In *Likins-Foster Honolulu Corp.* v. *Commissioner of Internal Revenue*, 10 Cir., 417 F. 2d 285, 292, cert. denied 397 U.S. 987, we recognized the purpose and effect of § 482, and the regulations thereunder. Treasury Regulations on Income Tax (1954), 26 C.F.R. § 1.482–1(b) and (c), provide that the standard to be applied in every case of a § 482 allocation "is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer" and that:

> The authority to determine the true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

During the tax years in question Utah Bank, Idaho Bank, Management Company, and Security Life were all wholly owned subsidiaries of Holding Company and under its control. We are concerned with allocation of income from Security Life to the two banks. That income consists of a

portion of Security Life's share of premiums paid by borrowers from the banks and received by Security Life under its reinsurance treaties. The test to be applied is whether the banks' income with respect to the borrowers' purchase of credit insurance was other than it would have been had the banks in the conduct of their affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. *Davis* v. *United States,* 10 Cir., 282 F. 2d 623, 626. Application of that test to the facts presented is not easy.

The two banks are national banks. Section 92, 12 U.S.C., authorizes national banks located in a place having a population not to exceed 5,000 inhabitants to act as an insurance agent. In 1963, an administrative ruling by the Comptroller of the Currency purportedly authorized every national bank, regardless of where located, to enter the insurance agency field. That ruling was nullified by *Georgia Association of Independent Insurance Agents, Inc.* v. *Saxon,* N.D. Ga., 268 F. Supp. 236, affirmed 5 Cir., 399 F. 2d 1010, on the ground that, although § 92 does not explicitly prohibit banks in places with a population of over 5,000 from acting as insurance agents, it does so impliedly. In a different factual situation the Fourth Circuit held that a national bank is prohibited from operating an insurance department except in towns of less than 5,000 inhabitants. See *Commissioner of Internal Revenue* v. *Morris Trust,* 4 Cir., 367 F. 2d 794, 795. We agree.

Section 93, 12 U.S.C., provides that for any violation of the chapter on national banks, the franchise of the banking association shall be forfeited and the directors individually shall be liable for damages sustained. The Tax Court found that because of the statutory provisions, and the advice of counsel relating thereto, the banks believed that it would be contrary to federal banking law to receive income resulting from their customers' purchase of credit insurance and they have never received commissions or reinsurance premiums arising from credit insurance transactions.

The Commissioner argues that the inhibitions of the banking laws do not preclude the operation of the tax laws. The banks concede the supremacy of the federal tax laws. Their position is that because of the prohibitions of the federal banking laws the banks have consciously remained

aloof from any entitlement to income from the sale of insurance.

For the six years after the banks began offering credit insurance and before the formation of Security Life, the bank dealt exclusively with unrelated insurance companies in an uncontrolled situation. The Tax Court found that in the conduct of their affairs with these insurance companies the banks "never received or attempted to receive commissions or reinsurance premiums resulting from their customers' purchase of credit insurance." Conversely the Tax Court made no finding that it Security Life did not exist the banks would then receive or attempt to receive any such income. In an uncontrolled situation with arm's length dealing the banks, on the basis of the findings made, would not have taxable income from the credit insurance transactions.

When all the underbrush is cut away, the theory of the Commissioner appears as a claim that the generation of the credit insurance business by the banks sustains the allocation of a portion of the premium income to them. He relies on *Local Finance Corporation* v. *Commissioner of Internal Revenue, supra.* We turn to that decision.

Local Finance presents a fact situation quite comparable to that confronting us. Commonly owned Indiana small loan companies offered credit insurance to their borrowers and about 90% of those borrowers took the insurance at the rate of $1.00 per year per $100 of coverage. For a part of the period the insurer paid a guaranteed commission of 40% of the net premiums, plus certain extras, to an officer of the finance companies who, upon receipt, assigned the amount to the parent company. Later, a controlled life insurance company was organized and it reinsured the risks. Indiana law forbade finance companies from receiving any income other than interest on loans. Each finance office had a licensed insurance agent. The Commissioner allocated a portion of both the commission income and the reinsurance income to the parent. The rationale of the Tax Court opinion in Local Finance is not clear. We believe that dissenting Judge Fay's analysis is correct. He said, 48 T.C. 773 at 802:

> The majority opinion also relies upon section 482 for support in allocating the income to petitioners in order to clearly reflect income. The premise of this

approach is the previously reached conclusion that petitioners have earned the income by the performance of various services and have exercised a power of disposition over this income to channel it to the reinsurance company.

In affirming the Tax Court, the Seventh Circuit said, 407 F. 2d 629 at 632 and 633:

> The commissioner's allocation had the effect of compensating the finance companies for their efforts in generating and processing the life insurance.
>
> * * * * *
>
> However little the finance companies did to earn this money, they performed those minimal services which were the *sine qua non* of the insurance business.

The Commissioner now urges on us the generation of business theory. He says in his brief that "the effect of the Commissioner's allocation is to compensate Utah Bank and Idaho Bank for their efforts in generating and processing the credit insurance."

Generation of income differs from assignment of income. It is fundamental that a taxpayer cannot assign a portion of his income in order to avoid tax liability on it. See *Lucas* v. *Earl,* 281 U.S. 111. Also the power to dispose of income is the equivalent of ownership. *Helvering* v. *Horst,* 311 U.S. 112, 118. These principles are grounded on rights in or flowing from income. See *Poe* v. *Seaborn,* 282 U.S. 101, 117.

The position of the Commissioner in effect is that whoever generates income must include the amount thereof in his gross income. The fallacy of this position was exposed by the Tax Court in *Teschner* v. *Commissioner of Internal Revenue,* 38 T.C. 1003, 1007, when it said:

> If this were the law, agents, conduits, fiduciaries, and others in a similar capacity would be personally taxable on the proceeds of their efforts. The charity fund-raiser would be taxable on sums contributed as the result of his efforts. The employee would be taxable on income generated for his employer by his efforts. Such results, completely at variance with every accepted concept of Federal income taxation, demonstrate the fallacy of the premise.

See also *Basye* v. *United States,* N.D. Calif., 295 F. Supp. 1289, 1292-1295.

Indeed, the acceptance of the generation of business theory would have alarming consequences on normal commercial practices such as all types of referral business and security commission giveups. See *Scieroe* and *Gerber,* "Section 482—Still Growing at the Age of 50," 46 Taxes 893, 900-902 (Dec. 1968). We believe that in principle it runs contrary to all court and Tax Court decisions except Local Finance.

From the standpoint of principle the case at bar is indistinguishable from such cases as *Nichols Loan Corporation of Terre Haute* v. *Commissioner of Internal Revenue,* 21 T.C.M. 805, reversed on other grounds, 7 Cir., 321 F. 2d 905 (deduction by small loan companies of expenses attributable to credit insurance); *Campbell County State Bank, Inc., of Herreid, South Dakota* v. *Commissioner of Internal Revenue,* 37 T.C. 430, reversed on other grounds, 8 Cir., 311 F. 2d 374 (attribution of income and expenses of commonly owned insurance agency to bank); *L. E. Shunk Latex Products, Inc.* v. *Commissioner of Internal Revenue,* 18 T.C. 940 (allocation to manufacturer of part of income of controlled outlet when manufacturer was prohibited by maximum price regulations from receiving the income sought to be allocated); *Jaeger Motor Car Company* v. *Commissioner of Internal Revenue,* 17 T.C.M. 1098, 7 Cir., 284 F. 2d 127, cert. denied 365 U.S. 860 (anticipatory transfer of insurance income from agent to controlled company); *Moke Epstein, Inc.* v. *Commissioner of Internal Revenue,* 29 T.C. 1005 (insurance commissions received by president of taxpayer); and *Ray Waits Motors, Inc.* v. *United States,* E.D. S.Car., 145 F. Supp. 269 (insurance commissions received by president of taxpayer).

Even though the credit insurance emanated from the banks in connection with their loan business, the result does not follow that the banks should be taxed for income which they neither earned nor received. They did not earn it because (1) they were not licensed insurance agents, (2) they were impliedly prohibited by federal law from operating an insurance business, (3) their participation required minimal effort and negligible cost compatible with the added protection which they secured for loan payment, and (4) they had no underwriting risk. True it is that they physically received the premium payments but in so doing

they acted only as a conduit to pass them on intact to others who were legally entitled thereto.

Consideration of §§ 61 and 482 separately or in tandem does not change the result. The § 61 cases such as *Lucas* v. *Earl, supra,* and *Helvering* v. *Horst, supra,* are not pertinent because the banks neither assigned nor otherwise disposed of income. They simply had no income from the credit insurance business. We are unwilling to extend those decisions to situations where the taxpayer has the power to channel profitable business.

The test for allocations under § 482 is arm's length dealing with an uncontrolled taxpayer. As the Tax Court recognized, in arm's length dealings with independent insurers before the organization of Security Life the banks did not receive income from credit insurance premiums. In our opinion the change to the reinsurance arrangement with National and Security Life did not change the situation so far as the income of the banks is concerned. They handled the business in the same way and were under the same inhibitions. The change in operations was for the benefit of Holding Company, not the banks.

We recognize the established rules that substance prevails over form, that the Commissioner has a wide discretion which we may not upset unless it is used arbitrarily or capriciously, and that the burden of persuasion lies on the taxpayers. These do not change the result. Generation of business is not enough to impose federal income tax liability. The effect of the action of the Commissioner and the decision of the Tax Court is to allocate approximately $800,000 in income to the banks and charge them with nearly $400,000 in tax deficiencies thereon. The banks have not received, and in all probability never can receive, the income because of the present diverse public ownership of the parent of the banks and the parent of Security Life. We believe that the § 482 allocations made by the Commissioner are arbitrary and capricious and inconsonant with the basic concepts of federal income taxation. To the extent that this opinion is inconsistent with that in Local Finance we respectfully disagree with the decision.

Because it upheld the Commissioner's allocations of income to the banks, the Tax Court rejected his alternative allocation to Management Company. Counsel for the Commissioner say that there is an adequate basis for the alternative allocation but we cannot answer that question on

the record presented. It must be considered in the first instance by the Tax Court.

In Nos. 611-69 and 612-69 the judgments are severally reversed. In No. 613-69 the judgment is reversed and the case is remanded to the Tax Court for further consideration.

UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Nos. 611-69, 612-69, 613-69

[*Captions Omitted*]

JUDGMENT

Before Honorable Jean S. Breitenstein and Honorable Oliver Seth, Circuit Judges; and Honorable George Templar, District Judge.

January Term—January 21, 1971

These consolidated cases came on to be heard on the petitions for review from the United States Tax Court and were argued by counsel. On consideration whereof, it is ordered as follows:

1. In Cases Nos. 611-69 and 612-69 the decisions of the Tax Court are severally reversed.
2. In Case No. 613-69, the decision of the Tax Court is reversed and the case is remanded to the Tax Court for further consideration.

HOWARD K. PHILLIPS,
Clerk.

By HELEN R. BARTHA,
Deputy Clerk.

A true copy.
Teste.
Howard K. Phillips,
Clerk, U.S. Court of Appeals, Tenth Circuit.
By Helen R. Bartha,
Deputy Clerk.

SUPREME COURT OF THE UNITED STATES

No. 70-305

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

FIRST SECURITY BANK OF UTAH, N.A., ET AL.

ORDER ALLOWING CERTIORARI. Filed October 12, 1971.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Tenth Circuit is granted.

☆ U.S. Government Printing Office: 1971—448-341/272

70-305

No. ~~1850~~ 1

In the Supreme Court of the United States

OCTOBER TERM, 1970

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FIRST SECURITY BANK OF UTAH, N.A., ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

ERWIN N. GRISWOLD,
Solicitor General,
JOHNNIE M. WALTERS,
Assistant Attorney General,
MATTHEW J. ZINN,
Assistant to the Solicitor General,
BENNET N. HOLLANDER,
JOHN S. BROWN.
Attorneys,
Department of Justice,
Washington, D.C. 20530.

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v.

FIRST SECURITY BANK OF UTAH, N.A., ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgments of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (Appendix A, *infra,* pp. 17–35) are not reported. The opinion of the court of appeals (Appendix B, *infra,* pp. 37–50), reversing the Tax Court, is reported at 436 F. 2d 1192.

JURISDICTION

The judgments of the court of appeals were entered on January 21, 1971 (Appendix C, *infra,* pp. 51–52). By

order dated April 12, 1971, Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including June 20, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, pursuant to Section 482 of the Internal Revenue Code, the Commissioner properly allocated to the respondent national banks the commission portion of the credit life insurance premiums paid by their borrowers in connection with loans, where respondents offered the life insurance to their borrowers ultimately on behalf of a life insurance company under common ownership and control with respondents.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 61 and 482 of the Internal Revenue Code of 1954, of Section 1.482-1 of the Treasury Regulations on Income Tax (1954 Code), and of Sections 5202 and 5239 of the Revised Statutes are set forth in Appendix D, *infra*, pp. 53–57.

STATEMENT

Respondents, First Security Bank of Utah, N.A., and First Security Bank of Idaho, N.A., are wholly-owned subsidiaries of First Security Corporation ("Holding Company"), a publicly owned bank holding company. Since 1948, respondents have offered to their borrowers credit life, health and accident insurance which discharges the debt if a borrower dies or becomes incapacitated during the term of his loan. (Appendix A, *infra*, pp. 18–22.)

From 1948 to April, 1954, the credit life insurance offered by respondents was written by two independent insurance companies. Both companies paid commissions ranging from 40 to 55 percent of the premiums collected to Ed D. Smith & Sons ("Smith"), a wholly-owned subsidiary of Holding Company engaged in the business of selling life and casualty insurance. (Appendix A, *infra,* pp. 20–22.)

Late in 1953, American National Life Insurance Company of Galveston, Texas ("American National") recommended a new plan to Holding Company. Under American National's plan, Holding Company would create a life insurance subsidiary, and American National would write the credit life insurance to be offered by respondents, and then reinsure all of the risk under those policies with Holding Company's life insurance subsidiary. In its initial years, the subsidiary would utilize American National's actuarial, accounting and other operating services on a fee basis. (Appendix A, *infra,* pp. 22–23.)

Holding Company adopted American National's plan and in June, 1954, formed a wholly-owned life insurance company, First Security Life Insurance Company of Texas ("Security Life"). For a fee of approximately 15 percent of the insurance premiums, American National, from 1954 through 1959, provided operating services to Security Life as planned, maintained Security Life's books and records, and computed its required reserves. Security Life received the balance of the premium dollar for the assumption of all of the risk under the insurance policies. (Appendix A, *infra,* pp. 20, 24–25.)

Security Life's sole source of business income was reinsurance premiums, and its reinsurance business was very profitable. By the end of 1954, Security Life was reinsuring $6.5 million of credit life insurance. By the end of 1959, Security Life was reinsuring $41.3 million of credit life insurance. Security Life was able to retain after all expenses—including American National's fee—52.5 percent of the total premiums. Its expenses, in addition to that fee, consisted primarily of bank charges, taxes and claim settlement expenses. Security Life's profit for the five-year period was more than $1 million. (Appendix A, *infra*, pp. 26–28.)

Respondents had numerous banking offices and maintained a routine procedure for offering credit life insurance to their borrowers. A loan officer explained the availability and function of credit life insurance to a customer and, if the customer desired the insurance, the loan officer gave him the necessary application forms. Upon receipt of the executed application, respondents' personnel completed a certificate of insurance, and either collected the premium from the customer or added it to his loan. Respondents' employees then forwarded the completed forms and premiums to First Security Company ("Management Company"), another Holding Company subsidiary which provided management services for the group. Management Company made records of insurance purchased and forwarded the forms and premiums to American National. Management Company also performed the necessary paper work when claims were filed under the policies. The cost to respondents of

processing the credit life insurance purchased by their borrowers from 1955 through 1959 was $8,929 and $9,826, respectively. The cost to Management Company of processing the insurance during the same period was $10,150. (Appendix A, *infra,* pp. 19, 21, 25–26.)

Both before and after the organization of Security Life in 1954, respondents offered credit life insurance to customers at the uniform rate of $1 per $100 of coverage per year on a decreasing term basis. This was the rate commonly charged in the credit life insurance industry. (Appendix A, *infra,* p. 26.)

Sections 5202 and 5239 of the Revised Statutes (Appendix D, *infra,* pp. 55–57) apparently prohibit national banks, under threat of criminal sanctions, from acting as insurance agents in places having a population of more than 5,000. From the time respondents began offering credit life insurance to their customers in 1948, their officers and those of Holding Company believed that it would be contrary to federal banking law for respondents to receive income resulting from their customers' purchases of credit life insurance. Accordingly, respondents have never received commissions or reinsurance premiums resulting from such purchases; rather, the commissions and reinsurance premiums have always been paid to corporations under common ownership with respondents. Specifically, from 1948 to April, 1954, the commissions were paid to Smith, and thereafter the reinsurance premiums were paid to Security Life. (Appendix A, *infra,* pp. 22, 24, 27, 29.)

Section 482 of the Internal Revenue Code (Appendix D, *infra,* p. 53) empowers the Commissioner to

allocate income among "two or more organizations, trades, or businesses * * * owned or controlled directly or indirectly by the same interests * * * if he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses." Acting under this provision, the Commissioner allocated 40 percent of the premium income to respondents for the period January 1, 1955 to December 31, 1959, and determined deficiencies accordingly. This allocation was to compensate respondents for selling and processing the credit life insurance and thereby to reflect their income clearly. For protective purposes, the Commissioner alternatively asserted deficiencies against Management Company by means of a similar allocation of premium income. Both respondents and Management Company sought redeterminations of the deficiencies in the Tax Court.[1] (Appendix A, *infra*, pp. 29–31.)

That court held that the case was controlled by its reviewed decision favorable to the government (two judges dissenting) in *Local Finance Corp.* v. *Commissioner,* 48 T.C. 773, affirmed, 407 F. 2d 629 (C.A. 7), certiorari denied, 396 U.S. 956, and sustained the Commissioner's determination that 40 percent of the premium income was allocable to respondents. It accordingly did not reach the Commissioner's alternative allocation. (Appendix A, *infra,* pp. 31–32, 34–35.) Respondents appealed, and the Commissioner took a pro-

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[1] The Tax Court's jurisdiction to redetermine the deficiencies rested on Section 6214(a) of the Internal Revenue Code.

tective cross-appeal for review of the decision favorable to Management Company. The court of appeals reversed the decisions of the Tax Court against respondents, and also reversed the decision of the Tax Court for Management Company. It remanded the case for further consideration of the Commissioner's alternative allocation. (Appendix B, *infra,* p. 50.)

REASONS FOR GRANTING THE WRIT

1. The decisions below is in conflict with the decision of the Seventh Circuit in *Local Finance Corp.* v. *Commissioner,* 407 F. 2d 629, certiorari denied, 396 U.S. 956. The court below acknowledged the conflict, observing (Appendix B, *infra,* p. 46) that "Local Finance presents a fact situation quite comparable to that confronting us", and stated (Appendix B, *infra,* p. 50) that "[t]o the extent that this opinion is inconsistent with that in Local Finance we respectfully disagree with that decision." These conflicting decisions have created uncertainty and inequity in the application of Section 482 of the Code to lending institutions under common ownership and control with so-called "captive insurance companies."

There are no significant factual differences between *Local Finance* and this case. As the Tax Court pointed out (Appendix A, *infra,* p. 31), the facts of the two cases "[i]n all essential respects * * * are the same * * *." The critical facts are that in both cases lending institutions, performing virtually the same services, solicited insurance business for a commonly controlled insurance company, and reported none of the income resulting from the insurance activities as

their own.[2] In both cases, controlled corporate groups sought to achieve considerable tax savings by having the commission element of the insurance premiums included in the income of their life insurance subsidiaries,[3] which are subject to a lower effective tax rate[4] than their other subsidiaries. The only distinction between the cases is that the lending institutions in *Local Finance* were prohibited from acting as insurance agents by Indiana law, whereas here the source of the alleged proscription is federal law. This is a distinction without a difference, as respondents conceded below (Appendix B, *infra*, p. 45).

2. The arrangements typified by the instant case and by *Local Finance* are, moreover, common to the lending business, because of the natural relationship be-

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[2] Even the premiums charged in the two cases were the same. The Tax Court (48 T.C. at 777, 786) and the Seventh Circuit (407 F. 2d at 631) in *Local Finance*, and the Court of Claims in *Alinco Life Ins. Co.* v. *United States*, 373 F. 2d 336, 337–338, all have recognized that the standard $1 per $100 premium rate is sufficient to allow insurers to pay commissions or acquisition costs.

[3] Since the Commissioner's allocation was to compensate respondents for selling and processing insurance, the fact that they had no underwriting risk, relied upon by the court of appeals (Appendix B, *infra*, p. 49), is irrelevant. What is relevant is that here, as in *Local Finance* (407 F. 2d at 633), the lending institutions "performed those minimal [but crucial] services which were the *sine qua non* of the insurance business."

[4] All of the years involved in *Local Finance* were subject to the provisions of the Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112. Here, the years 1955–1957 are governed by the Life Insurance Company Tax Act of 1955, c. 83, 70 Stat. 36. The later years are subject to the provisions of the 1959 Act, which, as amended, remain in force today. See Sections 801–820 of the Code. Under both acts, life insurance companies are accorded preferential tax treatment.

tween that business and the credit life insurance business. Indeed, when Congress enacted the Life Insurance Company Tax Act of 1955, c. 83, 70 Stat. 36, it recognized this relationship and the potential tax abuses, and specifically contemplated that Section 482 would be used in captive insurance company cases.[8] Both committee reports on the Act provide (H. Rep. No. 1098, 84th Cong., 1st Sess., p. 7; S. Rep. No. 1571, 84th Cong., 2d Sess., p. 8):

> There is a potential abuse situation in the case of the so-called captive insurance companies. It may be possible for a finance company, for example, to establish a subsidiary life insurance company that will issue life insurance policies in connection with the business of the parent. If the subsidiary charges excessive premium on this business, a portion of the income of the parent company can be diverted to the life insurance company. It is believed that section 482 of the Internal Revenue Code of 1954 (relating to allocation of income and deductions among related taxpayers) provides the Secretary of the Treasury ample regulative authority to deal with this problem.

The congressional concern has proved well-founded.[9]

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[8] Since the preferential treatment of life insurance companies continues under the 1959 Act (see n. 4, supra), the problem caused by a diversion of income from a lender to a related insurer persists as illustrated by the instant case and by *Local Finance*.

[9] Respondents contended below, in reliance on the tax-writing committees' reference to "excessive premium," that Congress was not concerned with cases such as this one, where borrowers paid the industry-wide premium rate for credit insurance (see n. 2, *supra*), but only with situations in which borrowers paid more

We are advised by the Internal Revenue Service that, in addition to the instant case, there are presently pending, judicially and administratively, substantially identical cases involving 22 groups of related taxpayers[7] in which the net tax in dispute is estimated to exceed $67 million.[8] The largest of these groups consists of some 1,000 related taxpayers. Moreover, after the decision in *Local Finance* and before the decision below, the Internal Revenue Service settled cases, strictly on the basis of the *Local Finance* holding, with seven groups of related taxpayers which agreed to pay approximately $10 million of net tax.[9] A substantial number of additional cases is certain to

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than the standard rate. This reading of the legislative history is incorrect. So long as a lender is fairly compensated for its services, there would be no diversion of income to the related insurer, and therefore no occasion to invoke Section 482, even if the borrower pays more than the going rate. There is a diversion, and Section 482 would come into play, however, whether the borrower pays the going or a higher rate, if the insurer fails to compensate the lender for its services. In such a situation, the insurer has charged an "excessive premium," and it is in this sense that Congress used the quoted term.

[7] One of these 22 groups is the First Security group (including respondents), which has docketed cases pending for later years.

[8] We refer to the "net tax in dispute" to make it clear that the revenue estimate is based only on the Commissioner's proposed primary allocations and is not inflated by the inclusion of the alternative allocations made to protect the revenues if the primary allocations are not sustained. Further, the estimate has been adjusted downward to reflect the fact that the deficiencies arising from the Commissioner's primary allocations would be partially offset by reductions in the income of the captive insurance companies.

[9] Four of these seven groups are among the 22 groups which have cases pending for later years.

arise in view of the obvious advantages accruing to an affiliated group of corporations which engages in both lending and credit life insurance activities. Until this Court provides a definitive solution, responsible government officials and private counsel will, as a practical matter, be unable to advise their respective clients to resolve problems such as those raised here, short of litigation. And, unless the Court resolves the present conflict in the circuits, lending institutions and captive insurance companies in different parts of the nation will be taxed differently even though they are involved in virtually identical commercial undertakings.

There is, to be sure, a substantial factual element in cases of this type. Factual differences between cases might justify a particular percentage allocation in one case and a higher or lower percentage allocation in another. But the court below did not hold that the Commissioner should have allocated some percentage less than 40 percent of the premiums to respondents, but rather that he was without power to make any allocation at all. As the court put it (Appendix B, *infra*, p. 50), the Commissioner's Section 482 allocations were "arbitrary and capricious and inconsonant with the basic concepts of federal income taxation." Furthermore, where as here and in *Local Finance*, the underlying facts are not in dispute, the differences in result cannot be ascribed to the facts, but must be attributed to differing interpretations of Section 482 by the Tenth and Seventh Circuits. The issue posed thus goes to the meaning and scope of that provision, and is one that is appropriate for resolution by this Court.

3. Although Section 482 was first enacted as Section 45 of the Revenue Act of 1928, c. 852, 45 Stat. 791, 806, it has not previously been considered by the Court on the merits. The statute was designed "to prevent evasion [of taxes by related taxpayers] (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability." H. Rep. No. 2, 70th Cong., 1st Sess., pp. 16–17. It is settled that in applying the provision, the applicable standard is "that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treasury Regulations on Income Tax (1954 Code), Section 1.482–1(b)(1) (Appendix D, *infra,* pp. 53–55); *Oil Base Inc.* v. *Commissioner,* 362 F. 2d 212, 214 (C.A. 9), certiorari denied, 385 U.S. 928.

While purporting to adhere to this standard (Appendix B, *infra,* pp. 43–46, 49–50), the court below applied Section 482 erroneously and in a manner which we believe seriously threatens to impair its continuing effectiveness. Respondents, the court said, could not be taxed on any part of the commissions or insurance premiums because they did not *receive* them (Appendix B, *infra,* pp. 45–46, 49–50), or *earn* them (*id.,* p. 50), but only *generated* the business or income (*id.,* pp. 46–50). All of this misconstrues Section 482.

Application of that section is, of course, not dependent on the receipt of income. See *Asiatic Petroleum Co.* v. *Commissioner,* 79 F. 2d 234, 236 (C.A. 2), certiorari denied, 296 U.S. 645. Indeed, an allocation of gross income thereunder presupposes that the in-

come was not *received* by the taxpayer which has so arranged its affairs as to divert the income to another.

Nor is the question whether respondents "earned" the income relevant under Section 482. See *Rubin* v. *Commissioner*, 429 F. 2d 650, 653 (C.A. 2). That is the issue under Section 61 of the Code (Appendix D, *infra*, p. 53), which provides, to the extent pertinent here, that "gross income means all income from whatever source derived, including * * * [c]ompensation for services, including fees, commissions, and similar items * * *." To hold that the same standard applies under Section 482 would make that provision redundant, at least insofar as allocations of gross income are concerned.

It is unclear precisely what the court of appeals meant when it said that respondents only "generated" the business or income. Use of this term, however, cannot conceal that respondents' income was less than it would have been had they been dealing with an unrelated insurance company during the years in issue. From 1948 to April, 1954, respondents performed all of the services incident to the sale of credit life insurance to their borrowers, and during that period two independent insurers paid commissions of 40 to 55 percent of the premiums collected to Smith, an affiliate of respondents. Thereafter respondents performed the same services for Security Life, a related insurer, but did not charge Security Life for these services. These facts alone are sufficient to show that respondents did not deal with Security Life as they

had dealt with unrelated insurers, and that an allocation is necessary to reflect their income clearly.[10]

The apparent prohibitions of federal banking law cannot alter this result. Respondents interpret Sections 5202 and 5239 of the Revised Statutes as prohibiting them from receiving income from acting as life insurance agents, but not from offering life insurance at the industry-wide premium rate. Their principal argument, apparently accepted by the court of appeals (Appendix B, *infra*, pp. 44–46, 49–50), is that the Commissioner's allocation is unauthorized because Section 482 is limited to allocations of income which may be lawfully received. But Section 482 grants the Commissioner authority to allocate income and deductions between related organizations not only when this "is necessary [in order] to prevent evasion of taxes" but also when necessary "clearly to reflect the income of any such organizations." *Central Cuba Sugar Co.* v. *Commissioner*, 198 F. 2d 214, 215 (C.A. 2), certiorari

[10] The fact, relied on by the court of appeals (Appendix B, *infra*, pp. 45–46, 49, 50), that even before Security Life's organization in 1954, no portion of the insurance premiums was paid to respondents, is no more relevant than the same fact in later years. The critical point is that when respondents dealt with independent insurers, those insurers paid a commission, whereas Security Life did not. That the commissions were paid to Smith, which was in no way involved in the sales of credit life insurance here in dispute, does not help respondents' case, but rather emphasizes Holding Company's power to designate which of its subsidiaries would receive the commissions. And even Holding Company did not consider the fact of receipt dispositive of the income tax consequences, for although it selected Smith to receive the commissions, it nevertheless had Management Company report them for tax purposes.

denied, 344 U.S. 874. Thus, even if the business arrangements adopted were required to, and did, satisfy federal banking law, the question remains whether respondents' income was clearly reflected. The answer to this question turns on federal tax law, not on federal banking law (cf. *Nat'l Securities Corp.* v. *Commissioner,* 137 F. 2d 600, 602 (C.A. 3), certiorari denied, 320 U.S. 794), and under the former, illegal gains, like legal gains, are taxable whether received or not. Compare *James* v. *United States,* 366 U.S. 213, with *Bailey* v. *Commissioner,* 52 T.C. 115, 119, affirmed *per curiam,* 420 F. 2d 777 (C.A. 5).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.
JOHNNIE M. WALTERS,
Assistant Attorney General.
MATTHEW J. ZINN,
Assistant to the Solicitor General.
BENNET N. HOLLANDER,
JOHN S. BROWN,
Attorneys.

JUNE 1971.

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[illegible] U. S. [illegible]. Thus, even if the business are [illegible] required [illegible] and [illegible], namely [illegible] the question remains whether [illegible] affected. The answer [illegible] Federal tax law, not on [illegible] former, illegal [illegible] whether [illegible] 119, and [illegible]

[illegible]

Respectfully submitted.

[illegible]
Solicitor General.
[illegible]
Assistant Attorney General.
[illegible]
Assistant to the Solicitor General.
[illegible] HOLLAND,
[illegible]
Attorneys.

[illegible]

APPENDIX A

Tax Court of the United States

T.C. Memo. 1967–256

FIRST SECURITY BANK OF UTAH, N.A., ET AL.,[1] PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 1190–63, 1191–63, 1216–63

Filed December 27, 1967

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, *Judge:* Respondent determined deficiencies in the petitioners' income taxes as follows:

Docket No.	Petitioner	Taxable year	Deficiency
1190-63	First Security Bank of Utah, N.A.	1954	$68,250.00
		1955	28,775.81
		1956	54,526.56
		1957	77,862.91
		1958	159,371.46
		1959	109,166.60
1191-63	First Security Company	1956	95,997.48
		1957	128,400.83
		1958	262,124.10
		1959	179,550.34
1216-63	First Security Bank of Idaho, N.A.	1954	68,250.00
		1955	26,139.85
		1957	160,302.56
		1958	102,752.67

During the trial, respondent stated that he would not pursue one of the issues raised in the pleadings.

[1] Proceedings of the following petitioners are consolidated herewith: First Security Company, Docket No. 1191–63, and First Security Bank of Idaho, N.A., Docket No. 1216–63.

We therefore conclude that he has abandoned it. The issues remaining for decision are:

(1) Whether respondent erred in allocating, pursuant to sections 61 and 482,[2] to petitioners First Security Bank of Utah, N.A., and First Security Bank of Idaho, N.A., a portion of the income which First Security Life Insurance Company of Texas received from January 1, 1955, to December 31, 1959, for reinsuring credit life, health, and accident insurance,[3] or in the alternative, whether he erred in allocating, pursuant to said sections, to petitioner First Security Company a portion of said income which First Security Life Insurance Company of Texas received from January 1, 1956, to December 31, 1959; and

(2) whether respondent properly put section 482 in issue and, if so, whether he should have the burden of proof.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.

Petitioner First Security Bank of Utah, N.A. (hereinafter referred to as Utah Bank), is a national bank incorporated in 1882. It filed its Federal income tax returns for the taxable years involved herein on a calendar year basis with the district director of internal revenue, Salt Lake City, Utah. Its principal

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[2] All statutory references are to the Internal Revenue Code of 1954, unless otherwise specified.

[3] The statutory notice received by petitioner First Security Bank of Idaho, N.A., contained adjustments to certain net operating loss carrybacks. Because of these adjustments, this Court has jurisdiction under section 6214(b) to determine the correctness of respondent's allocations to this petitioner for the years 1956 and 1959.

place of business was Salt Lake City, Utah, when it filed its petition in this case.

Petitioner First Security Bank of Idaho, N.A. (hereinafter referred to as Idaho Bank), is a national bank, incorporated as such in 1941 after operating since 1865 as a state bank. It filed its Federal income tax returns for the taxable years involved herein on a calendar year basis with the district director of internal revenue, Boise, Idaho. Its principal place of business was Boise, Idaho, when it filed its petition in this case.

Petitioner First Security Company (hereinafter referred to as Management Company) is a corporation organized under the laws of Utah in 1929. It filed its Federal income tax returns for the taxable years involved herein on a calendar year basis with the district director of internal revenue, Salt Lake City, Utah. Its principal place of business was Salt Lake City, Utah, when it filed its petition in this case.

Petitioners are wholly-owned subsidiaries of the First Security Corporation (hereinafter referred to as Holding Company). It is the oldest bank holding company in existence. It is under the supervision and control of, and is regularly examined by, the Federal Reserve System. It is qualified under and subject to the Bank Holding Company Act, 12 U.S.C. sections 1841 *et seq.* From 1954 through September 15, 1959, Holding Company had approximately 1,044,963 shares of common voting stock outstanding and from 2,000 to 3,000 shareholders residing in various states and foreign countries.

Holding Company has had a policy of business expansion and acquisition throughout its existence. The banking offices of its subsidiaries extend from the

Canadian border to the Arizona border. Moreover, it has entered into diversified enterprises other than banking.

From 1954 to September 15, 1959, Holding Company had the following wholly-owned subsidiaries, in addition to petitioners:

(a) The First Security Life Insurance Company of Texas (hereinafter referred to as Security Life), a corporation organized and licensed as an insurance company pursuant to the laws of Texas.

(b) Ed. D. Smith and Sons (hereinafter referred to as Smith), a Utah corporation. It had approximately twenty employees and sold life and casualty insurance. It had a yearly premium volume of approximately $800,000.

(c) First Security Insurance Agency, Inc. (hereinafter referred to as Agency), an Idaho corporation. It sold insurance and had a yearly premium volume of about $175,000.

(d) Western Investment Corporation, an Idaho corporation holding various assets.

(e) First Security State Bank, a Utah State bank.

(f) First Security Bank, a Wyoming State bank.

(g) Security Savings and Loan Association, a Utah State savings and loan association; and

(h) First Security Savings and Loan Association, an Idaho State savings and loan association.

On September 15, 1959, Holding Company underwent a reorganization pursuant to the Bank Holding Company Act, *supra*. The banking subsidiaries, including the three petitioners herein, were placed in a newly-organized bank holding company. The shareholders of Holding Company received the stock of the new bank holding company. The nonbanking

subsidiaries, including Security Life, remained in the old holding company.[4]

Utah Bank and Idaho Bank have numerous banking offices. Both are subject to supervision, inspection, and control by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency and are regularly examined by them. The articles of incorporation of the banks limit them to the business of banking under the laws of the United States. Under the national banking laws, the members of the boards of directors of the banks are responsible for the proper operation of the banks. During the years in issue, Utah Bank had 141,000 to 192,000 depositors and $217,000,000 to $292,000,000 in deposits. During the same years, Idaho Bank had 113,000 to 131,000 depositors and $183,000,000 to $205,000,000 in deposits.

Management Company provides accounting and other management services to the other subsidiaries of Holding Company. Management Company is subject to control, supervision, and inspection by the Board of Governors of the Federal Reserve System and is regularly examined by it.

In 1948 Utah Bank and Idaho Bank began making available credit life, health, and accident insurance (hereinafter referred to as credit insurance)[5] to their customers. They did this for several reasons, including (1) to offer a service increasingly supplied by com-

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[4] Although the new holding company received the name of the old one—First Security Corporation—while the old one changed its name to First Security Investment Company, the term "Holding Company" will continue to refer to the pre-reorganization holding company.

[5] For a description of the credit insurance industry, see *Local Finance Corporation*, 48 T.C. 773 (1967), at 776 *et seq.*

peting financial institutions, (2) to obtain the benefits of the additional collateral which credit insurance provides by repaying loans upon the death, injury, or illness of the borrower, and (3) to provide an additional source of income—part of the premiums from the insurance—to Holding Company or its subsidiaries.

From 1948 through 1952, Credit Life Insurance Company of Springfield, Ohio, wrote the credit insurance which Utah Bank and Idaho Bank had available for their customers. Credit Life Insurance Company and Smith entered into agency agreements designating Smith as Credit Life's agent in writing the the insurance. Pursuant to the agreements, Credit Life paid commissions to Smith as follows:

Period	Amount of payment to Smith per agency agreement	Characterization of payment in agency agreement
9-24-48 through 6-1-50.	40 to 50 percent of net premiums collected, based on volume.	Commissions.
6-1-50 through 12-31-52.	55 percent of premiums	45 percent commission, 10 percent expense reimbursement.

From January 1, 1953, through April 1, 1954, American Bankers Life Assurance Company of Florida wrote the credit insurance which Utah Bank and Idaho Bank had available for their customers. American Bankers Life Assurance Company and Smith entered into an agency agreement designating Smith as American Bankers' agent in writing the insurance. Pursuant to the agreement, American Bankers paid commissions to Smith of 55 percent of the net premiums collected on life insurance and 50 percent of the net premiums collected on health and accident insurance.

Late in 1953, American National Insurance Company of Galveston, Texas (hereinafter referred to as

National),[6] approached Holding Company with a plan whereby National would write the credit insurance which Utah Bank and Idaho Bank made available to their customers. The plan called for Holding Company to create a life insurance subsidiary. The subsidiary's business would be to reinsure the risks of the credit insurance policies written by National for the customers of the two Banks. Profits from the business could be retained in the subsidiary for investment. In its initial years, the subsidiary would utilize National's established and experienced operating services—actuarial, accounting, etc.—on a fee basis. If the plan proved successful, the new insurance subsidiary could grow into a full-line, direct-writing insurance company.

Holding Company was one of many financial institutions which National approached with such a plan. During 1953 National concluded that lending institutions would soon begin to form their own life insurance companies to write the credit insurance which they made available to their customers. They based their conclusion upon the facts that writing credit insurance was proving to be a very profitable business and that there were considerable tax savings on premium income.[7] This potential move by lending institutions would ultimately deprive National and other independent insurance companies of their credit insurance business. To salvage what it could from the situation, National decided to encourage lending institutions to develop their own life insurance com-

[6] National is a leading nationwide insurance company. It is independent of and unrelated to Holding Company and its subsidiaries.

[7] The Life Insurance Company Income Tax Act of 1959 in large part eliminated the tax savings. See generally Mertens, sec. 44A.01 *et seq.*

panies by utilizing the operating services which National had developed for writing credit insurance. By charging a fee for the services, National would recoup something from its investment in the credit insurance business.

Holding Company decided to adopt National's plan. It did so for numerous reasons, including its policy of business expansion. To implement the decision, Holding Company incorporated Security Life in June 1954. Security Life was incorporated under the laws of Texas and approved by the Texas State Board of Insurance Commissioners. It had an initial capital of $25,000[8] and an initial paid-in surplus of $12,500.[9]

National began writing credit insurance for the customers of Utah Bank and Idaho Bank in April 1954. The insurance was reinsured with Security Life under contracts called reinsurance treaties. Under the treaties National received approximately 15 percent of the premium dollar for its managerial services and Security Life received the balance of the premium dollar for its assumption of 100 percent of the risk under the insurance policies.[10]

From April 1954 through 1959, National maintained Security Life's books and records and computed its required reserves. By purchasing the services of National, Holding Company effected considerable savings over what would have been the case

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[8] Security Life's capital was increased to $100,000 in 1956 through a $75,000 stock dividend.

[9] This was an unusually low capitalization with which to begin an insurance company. In 1954 Texas had low minimum capitalization requirements for incorporating insurance companies.

[10] The maximum on one life under the policies which Security Life reinsured was $5,000.

had it attempted to launch a full-line, direct-writing company from the outset. It is a common practice to begin an insurance company by reinsuring risks and, if successful, grow into a full-line, direct-writing company.[11] There is no basic actuarial or business difference between an insurance company which reinsures and a direct-writing company.

Utah Bank and Idaho Bank had a routine procedure for making credit insurance available to customers. A loan officer explained the availability and function of credit insurance to a customer. If the customer desired the insurance, the loan officer gave him application forms. The customer then filled in the application. After examining the application, Bank personnel filled in a certificate of insurance and either collected the preimum from the customer or added it to his loan. As the final step, Bank personnel forwarded the completed forms to Management Company for further handling.

Utah Bank and Idaho Bank did not require customers to purchase credit insurance. During the years in issue, less than one-half of the Banks' installment loan customers elected to take insurance and less than 13 percent of the Banks' real estate loan customers elected to take insurance.

The cost to Utah Bank and Idaho Bank of processing the insurance was negligible. For the five years in issue, the total cost to Utah Bank was $8,929.30 and the total cost to Idaho Bank was $9,826.43.[12]

Management Company's role in processing the credit insurance was in the nature of bookkeeping. It had no contact with the public with respect to writing

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[11] Security Life never developed into a full-line, direct-writing company.

[12] These figures are derived from an extensive time-cost study prepared by an employee of Management Company.

credit insurance. It received the forms, duplicate certificates, and premiums from Utah Bank and Idaho Bank. It then made records of insurance purchased and forwarded premiums to National. It also did the paper work when claims had to be filed under the policies.

The cost to Management Company of processing the insurance was negligible. For the five years in issue, the total cost was $10,150.34.[13]

Idaho Bank, Utah Bank, and Management Company were not parties to the legal relationships and obligations of the insurance policies. National wrote the insurance and the Banks' customers were its policyholders. Under the terms of the policies, National was responsible for payment of claims. Under the reinsurance treaties, Security Life was obligated to reimburse National for claims it paid.

Other than group policies, there were no contracts, agency agreements, or other legal connections between National and Idaho Bank, Utah Bank, or the employees of both. There were no contracts, agency agreements, or other legal connections between National and Management Company or its employees.

From 1948 through 1959, the credit insurance which Idaho Bank and Utah Bank made available to their customers was priced at the uniform rate of $1 per $100 coverage per year on a decreasing term basis. This was the rate commonly charged in the industry. It was accepted by the insurance commissioners of the states involved herein—Utah, Idaho, and Texas.

During the years in issue, Security Life paid state and Federal taxes, used its own stationery, made deposits and withdrawals from bank accounts in its own name, and invested in its own name. Its sole source

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[13] This figure is derived from the time-cost study described in footnote 12, *supra*.

of business income was reinsurance premiums. Its business expenses were primarily bank charges, taxes, and claims settlement expenses.

Security Life's credit insurance business was very profitable. Its yearly operations for the period 1955 through 1959 are reflected in the following table:

Yea	Net premium [1]	National's fee	Reinsurance premium received by Security Life	Claims and claims expenses	Net profit to Security Life
1955	$145,927.55	$24,765.65	$121,161.90	$45,340.38	$75,[illegible].52
1956	277,437.45	43,695.72	233,741.73	97,899.66	136,132.07
1957	367,612.62	55,590.64	312,021.98	114,014.49	198,007.49
1958 [2]	647,874.90	62,954.22	584,920.68	118,874.46	466,046.22
1959	477,389.43	71,608.43	405,781.00	149,948.92	255,832.08
Total	$1,916,241.95	$258,614.66	$1,657,627.29	$525,787.91	$1,131,839.38
Less closing Life Reserve, 12-31-59					110,806.00
Less general expense for period 1-1-55 through 12-31-55					16,339.00
Total profit					$1,004,694.38

[1] Gross premium less cancellations and adjustments.
[2] Includes 1958 reserve adjustment.

Security Life's operations for the years in issue are summarized in the following table in terms of percentages of total net premiums received.

Item:	*Percent of total net premiums received*
Fee paid to National	13.5
Claims paid	27.4
Life reserve on 12/31/59 and general expenses	6.6
Balance	52.5
Total	100.0

Security Life's balance sheets for the period January 1, 1955, through December 31, 1959, are summarized in the following table:

	1955	1956	1957	1958	1959
Assets	$161,370.52	$390,286.87	$648,586.43	$1,204,424.45	$1,050,220.71
Liabilities (including reserves)	13,076.98	22,295.00	30,277.60	271,479.06	197,687.00
Capital	25,000.00	100,000.00	100,000.00	100,000.00	100,000.00
Surplus:					
Paid-in	12,500.00	12,500.00	12,500.00	12,500.00	12,500.00
Unassigned		35,099.41			
Earned	110,793.54	220,392.46	505,808.83	820,445.39	[1] 740,033.71
	$161,370.52	$390,286.87	$648,586.43	$1,204,424.45	$1,050,220.71

[1] Security Life paid a dividend of $389,821.61 to Holding Company during 1959.

Although Security Life's business proved to be successful, there was no way to judge at the outset whether it would succeed. In relation to its capital structure, Security Life reinsured a large amount of risk. The following table shows the number of policies reinsured, the amount of risk it assumed, and the number of extra maximum claims which would have eliminated its surplus at the end of a year:

Year	Number of policies	Amount of risk at end of year	Number of extra maximum claims which would have eliminated surplus
1954	12,500	$6,488,000	3
1955	27,594	13,360,000	9
1956	34,368	21,105,000	28
1957	29,591	25,570,000	28
1958	32,155	36,761,000	50
1959	36,416	41,350,000	97

Furthermore, there were several aspects of Security Life's business which could have invited high mortality rates. Customers of the two Banks could obtain credit insurance without a health examination and there was no waiting period before the insurance

went into effect. In addition, Security Life was a relatively small insurance company and its policyholders lived in a relatively limited geographical area.

Since Utah Bank and Idaho Bank began making available credit insurance to their customers in 1948, the officers of Holding Company and of the two Banks have held the belief that it would be contrary to Federal banking law for the two Banks to receive income resulting from their customers' purchase of credit insurance. They based the belief on the advice of legal counsel. Pursuant to the belief, the two Banks have never received or attempted to receive commissions or reinsurance premiums resulting from their customers' purchase of credit insurance.

Petitioners Idaho Bank and Utah Bank reported no income from sales of credit insurance on their Federal income tax returns for the years 1955 through 1959. Petitioner Management Company reported no income from sales of credit insurance on its Federal income tax returns for the years 1956 through 1959.

In his statutory notices of deficiency, respondent allocated to petitioners Utah Bank and Idaho Bank the reinsurance premiums received by Security Life from 1955 through 1959. He also, alternatively, allocated to petitioner Management Company the reinsurance premiums received by Security Life from 1956 through 1959.[14] The pertinent explanatory material in each notice of deficiency is as follows:

> It is determined that the insurance premium[s] and/or commission income reported

[14] During the trial and on brief, respondent only urged the allocation of 40 percent of the net premiums which Security Life received from reinsuring credit insurance. He did not allocate any income which Security Life received for reinsuring risks on mortgage, twin-dollar, and borrow-by-check insurance, three types of insurance which Security Life reinsured in addition to what we refer to herein as credit insurance.

> as income by the First Security Life Insurance Company of Texas, a corporation, the stock of which is owned by The First Security Corporation, the same corporation which owns your stock, should have been reported by you. Therefore, your taxable income is increased as indicated for each of the taxable years 1955 [1956] through 1959.

In a different case than the one at bar, respondent has asserted a deficiency against Security Life for the years 1955 through 1959. More than three years before the trial of the present case, Security Life filed a sworn protest with the district director of internal revenue, Salt Lake City, Utah, contesting the asserted deficiency. Counsel for petitioners herein prepared Security Life's protest. To explain the difference between Security Life's case and the case at bar, the protest contains the following language:

> The issues involved are not at all related; each turns on its own set of facts and its own section of the Internal Revenue Code. The issue involved in the bank cases is whether the banks were the true earners of the income, and hence taxable under Section 482. The issue in this case is whether the reserves were established and maintained on an actuarial basis as required by Section 801(a).

In the case at bar, respondent never filed any document prior to the pretrial conference formally notifying petitioners that he intended to rely on section 482. Two days prior to the trial herein, respondent filed a motion for a pretrial conference pursuant to Rule 28, Rules of Practice of the Tax Court. In the motion, respondent stated that he would rely on section 482 as well as section 61.

OPINION

The first issue is whether respondent has properly put section 482 in issue.

Petitioners argue that because respondent did not specifically mention section 482 in his notices of deficiency, and because he did not otherwise specifically and formally notify petitioners prior to the pretrial conference that he would rely on section 482, he is barred from relying on that section. Alternatively, petitioners argue that if we permit respondent to rely on section 482, he should bear the burden of proof because the determination with respect to the section 482 issue in the statutory notices does not contain sufficient legal and factual grounds.

We do not agree with either argument. Petitioner's counsel knew three years in advance of the trial that respondent would rely on section 482. Moreover, petitioners do not allege surprise or suggest that they were prejudiced in any way by respondent's alleged omissions. It is clear from the record that petitioners' counsel were well prepared with an extensive and thorough case on the section 482 issue. In view of these circumstances, the cases which petitioners cite on this point are distinguishable. We hold that respondent has properly put section 482 in issue and that petitioners have the burden of proof.

The second issue is whether respondent erred in allocating, pursuant to sections 61 and 482, either to Utah Bank and Idaho Bank or to Management Company 40 percent of the net premiums which Security Life received during the years in issue for reinsuring credit insurance.

In all essential respects, the facts of the case at bar are the same as those in *Local Finance Corporation,*

48 T.C. 773 (1967). Because of our decision in that case, most of petitioners' arguments on this issue are untenable. Petitioners do, however, make two arguments concerning the actuarial soundness of respondent's allocations which are not foreclosed by our earlier decision.[15]

Petitioners' main actuarial argument is based upon the testimony of their expert actuary. The crux of the testimony is the opinion contained in the following exchange:

> Q. What is your opinion?
> A. The size and nature of the risk assumed by this company [Security Life] in relationship to its capital structure required it to retain every dollar that it could possibly do so.
> Q. To stay on an actuarially sound basis?
> A. Yes.

Petitioners' actuary based his opinion upon the amount of risk which Security Life reinsured and upon factors in its insurance operation which might have invited high mortality rates.

Petitioners claim that their actuarial evidence demonstrates that Security Life would have been actuarially unsound if it had paid an insurance commission to the Banks equal to what respondent now allocates to them. It follows, petitioners argue, that respondent's allocation pursuant to sections 61 and 482 is unreasonable.

We do not agree. The central fact upon which petitioners' actuary based his testimony was Security Life's initial capital structure of $37,500. In the above-quoted passage he said that Security Life assumed great risk "in relationship to its capital structure." Respondent's actuary pointed out that Security Life's initial capitalization was unusually low for an insur-

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[15] See *Local Finance Corporation*, *supra*, at 791.

ance company. Petitioners' actuary corroborated this with the following testimony:

> Now, within the life insurance industry there is a very much used rule of thumb for new life insurance companies that is to establish it with capital and surplus of approximately 100 times its maximum risk on one life.
>
> This is arbitrary and a rule of thumb, but it is also true that throughout the industry the amount that companies will retain on one life is closely in that neighborhood.

The maximum risk on one life under the policies reinsured by Security Life was $5,000. Using the formula suggested by petitioners' actuary, Security Life's initial capitalization should have been $500,000, not $37,500. If its initial capitalization had been $500,000 rather than $37,500, petitioners' actuarial evidence would be meaningless. The validity of the evidence, in other words, hinges upon the fact that Security Life began business as an undercapitalized insurance company. This evidence does not persuade us that respondent's allocation pursuant to sections 61 and 482 is unreasonable.

Petitioners make another actuarial argument based upon the fact that respondent, during trial and on brief, did not allocate to them Security Life's income from reinsuring risks on lines of insurance other than what we herein refer to as credit insurance. Petitioners contend that respondent ignored these lines because Security Life had a much higher claims experience with them than with credit insurance. Petitioners argue that this omission by respondent is a concession that a 40 percent allocation on the other lines of insurance would be unreasonable. They conclude that what is unreasonable for the other lines of insurance is also unreasonable for credit insurance.

We do not agree. Petitioners did not attempt to prove any business or actuarial similarities between Security Life's reinsurance of credit insurance and its reinsurance of other lines. It follows that we cannot draw inferences between the two lines. We do not decide what meaning, if any, attaches to the fact that respondent did not allocate Security Life's income from reinsuring the other lines of insurance.

Neither of petitioners' actuarial arguments persuades us that respondent's allocation pursuant to sections 61 and 482 is unreasonable. The arguments do not, therefore, distinguish the present case from *Local Finance Corporation, supra.* It follows that we must uphold as reasonable respondent's allocation of part of Security Life's income.

One problem remains—to which taxpayer should we allocate the income in question. Respondent, in his notices of deficiency, allocates the income either to Utah Bank and Idaho Bank or to Management Company.

Petitioners argue that the only taxpayers to which we can properly allocate the income are Smith and Agency, neither of which is a party herein. Their theory is based upon the facts that from 1948 through 1954 insurance commissions for the sale of credit insurance in the two Banks were payable to Smith and that during the years here in issue Smith and Agency held licenses to sell insurance. Because insurance commissions have never been payable to petitioners, and because none of the petitioners has ever held a license to sell insurance, they argue that it is logical to allocate the income to Smith and Agency, rather than to them.

We do not agree. Petitioners performed services with regard to the sale of credit insurance during the years in issue. Smith and Agency did not. Therefore, it is not proper to allocate the income to Smith and Agency. See concurring opinion in *Local Finance Corporation, supra,* at 797.

Among the petitioners, we allocate the income to Utah Bank and Idaho Bank. Our decision in *Local Finance Corporation* dictates this result.

Decisions will be entered under Rule 50.

APPENDIX B

United States Court of Appeals, Tenth Circuit

January Term, 1971

No. 611–69

FIRST SECURITY BANK OF UTAH, N.A., PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

No. 612–69

FIRST SECURITY BANK OF IDAHO, N.A., PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

No. 613–69

FIRST SECURITY COMPANY, PETITIONER-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLANT

APPEALS FROM DECISIONS OF THE TAX COURT OF THE UNITED STATES

Before BREITENSTEIN and SETH, Circuit Judges, and TEMPLAR, District Judge.

BREITENSTEIN, Circuit Judge.

These consolidated appeals from the Tax Court relate to the allocation of income among taxpayers. No. 611–69 is an appeal by First Security Bank of Utah, N.A., (Utah Bank) from the decision that for the years 1955 to 1959 inclusive there is a deficiency in income taxes due from the taxpayer in the amount of $187,863.92. No. 612–69 is an appeal by First Security Bank of Idaho, N.A., (Idaho Bank) from the holding that for the tax years 1955, 1957, and 1958 there is a deficiency of $210,714.41. No. 613–69 is a protective appeal by the Commissioner of Internal Revenue from the decision that there are no deficiencies in the income taxes due from First Security Company (Management Company) for the years 1956 to 1959 inclusive. The Tax Court held that approximately 40% of credit insurance net premiums paid by borrowers from the two banks, and reported by another corporation, were allocable to income of the banks. Jurisdiction is conferred by 26 U.S.C. § 7482(a). Venue for the appeal of the Idaho Bank is in this court pursuant to a stipulation made under § 7482(b)(2). The findings of fact and opinion of the Tax Court are not officially reported but are found at 26 T.C.M. 1320.

The taxpayers are national banks. They and a Wyoming bank, Management Company, and certain nonbanking affiliates were until 1959 wholly owned subsidiaries of First Security Corporation, a bank holding company which is publicly owned. During the years in issue Utah Bank had 141,000 to 192,000 depositors and $217,000,000 to $292,000,000 in deposits and Idaho Bank had 118,000 to 131,000 depositors and $183,000,000 to $205,000,000 in deposits. Management Company provided accounting and other managerial services to subsidiaries of Holding Company.

Since 1948 the banks have made available to their borrowers credit life, health, and accident insurance which pays off the debt in case the borrower dies or is incapacitated during the term of his loan. The Tax Court found that they did this "for several reasons, including (1) to offer a service increasingly supplied by competing financial institutions, (2) to obtain the benefits of the additional collateral which credit insurance provides by repaying loans upon the death, injury, or illness of the borrower, and (3) to provide an additional source of income—part of the premiums for the insurance—to Holding Company or its subsidiaries." The premium charge for the credit insurance was at the uniform rate of $1.00 per $100.00 of coverage per year on a decreasing term basis. This was the rate commonly charged in the industry and was accepted by the insurance commissioners of the states involved—Utah, Idaho, and Texas. The banks did not require their borrowers to purchase credit insurance. During the taxable years less than 50% of their installment loan customers and less than 13% of their real estate loan customers elected to take insurance.

The banks had a routine procedure for making credit insurance available to customers. A loan officer explained the function and availability of the insurance. If the customer desired the insurance, the loan officer gave him the application forms for completion. Bank personnel examined the application, made out a certificate of insurance, and either collected the premium from the customer or added it to his loan. There is no showing that any of the bank personnel were licensed insurance agents. As the final step, bank employees forwarded the completed forms and premiums to Management Company for further handling.

Management Company's role in processing the credit insurance was in the nature of bookkeeping. It had no contact with the public in respect to the writing of credit insurance. It received the forms, duplicate certificates, and premiums from the banks, made records of the insurance purchased, and forwarded the premiums to the insurance carrier. It also did the paper work when claims were filed under the policies.

The following items show pertinent facts with regard to the credit insurance which concerns us.

1. The number of policies written and the amount of risk at the end of each year, 1954 to 1959, inclusive, varied from a low of 12,500 and $6,483,000 respectively in 1954 to a high of 36,416 and $41,350,000 respectively in 1959.

2. The net premiums for the years 1955 to 1959 inclusive totalled $1,916,241.95.

3. The claims and claim expenses for the years 1955 to 1959 inclusive totalled $525,787.91.

4. For the years in issue the total cost to the Utah Bank for processing the insurance was $8,929.30, to the Idaho Bank $9,826.43, and to Management Company $10,150.34. The Tax Court described these costs as "negligible."

From 1948 to April 1, 1954, the credit insurance coverage on the banks' borrowers was carried first by Credit Life Insurance Company of Springfield, Ohio, and later by American Bankers Life Assurance Company of Florida, both of which were independent of Holding Company and its subsidiaries. Commissions varying from 40% to 55% of net premiums were paid to Ed. D. Smith & Sons which was an insurance agency and a wholly owned subsidiary of Holding Company.

American National Insurance Company of Galveston, Texas, an independent company, wrote a large volume of credit insurance. Foreseeing a change in the credit insurance business, National, late in 1953, approached Holding Company and other financial institutions with a plan whereby it would write credit insurance available to borrowers. The plan called for Holding Company to create a life insurance subsidiary. The subsidiary's business would be to reinsure the risks of the credit insurance policies written by National for the customers of Utah Bank and Idaho Bank. Profits from the business could be retained in the subsidiary for investment. In its initial years, the subsidiary would utilize National's established and experienced operating services, such as actuarial and accounting, on a fee basis. If the plan proved successful, the new subsidiary could grow into a full-line, direct-writing insurance company.

Holding Company adopted National's plan and in June, 1954, incorporated First Security Life Insurance Company of Texas under the laws of Texas with an initial capital of $25,000 and an initial paid-in surplus of $12,500. The credit insurance written by National for the two banks was reinsured with Security Life under contracts called reinsurance treaties. Thereunder National received approximately 15% of the premium dollar for its technical services and Security Life received the balance for its assumption of 100% of the risks under the policies. The maximum risk on one life under the policies reinsured by Security Life was $5,000.

In 1956, Security Life's capital was increased to $100,000. During the period it did not become a full-line, direct-writing insurance company. Although Security Life's business proved successful, this result was not assured at the outset. In relation to its capital

structure Security Life reinsured a large amount of risk. As noted by the Tax Court, several aspects of its business could have invited high mortality rates. Customers of the banks obtained credit insurance without a health examination and without a waiting period. Also, Security Life was a relatively small insurance company and its policyholders lived in a relatively limited geographical area.

During the years in issue, Security Life paid state and federal taxes, used its own stationery, made deposits and withdrawals from bank accounts in its own name, and reinvested in its own name. Its sole source of business income was from reinsurance premiums. Its business expenses were primarily bank charges, taxes, and claims settlements. It paid a dividend to Holding Company of $389,821.61 in 1959.

On September 15, 1959, as a result of a reorganization pursuant to the 1956 act regulating bank holding companies, see 12 U.S.C. § 1841 et seq., the Utah and Idaho banks became owned by First Security Corporation, a publicly held corporation, and Security Life became owned by First Security Investment Company, also a publicly held corporation. The parties have stipulated that as of February, 1967, there was a substantial difference in the ownership of the shares of the two companies.

On December 21, 1962, the Commissioner sent notices of deficiency to the taxpayers based on an allocation to the banks of approximately 47% of Security Life's premium income, during the years in issue, after payment of National's management fees. An alternative allocation was made to Management Company. On the authority of *Local Finance Corporation v. Commissioner of Internal Revenue,* 48 T.C. 773, affirmed, 7 Cir., 407 F. 2d 629, cert. denied 396 U.S. 956, the Tax Court upheld Commissioner's allocation

of income to the banks and denied his alternative allocation to Management Company. The banks have each appealed from the adverse decision on liability for tax deficiencies, and the Commissioner has taken a protective appeal from the conclusion of no deficiency due from Management Company.

Section 61 of the Internal Revenue Code of 1954, 26 U.S.C. § 61, defines gross income to mean all income from whatever source derived including, among specified items, "(1) Compensation for services, including fees, commissions, and similar items; (2) Gross income derived from business."

Section 482 of the Code, 26 U.S.C. § 482, covers allocations of income and deductions among taxpayers and provides that:

> In any case of two or more organizations * * * owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, * * * if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, * * *.

In *Likins-Foster Honolulu Corp.* v. *Commissioner of Internal Revenue,* 10 Cir., 417 F. 2d 285, 292, cert. denied 397 U.S. 987, we recognized the purpose and effect of § 482, and the regulations thereunder. Treasury Regulations on Income Tax (1954), 26 C.F.R. § 1.482–1(b) and (c), provide that the standard to be applied in every case of a § 482 allocation "is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer" and that:

> The authority to determine the true taxable income extends to any case in which either by inadvertence or design the taxable income, in

whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

During the tax years in question Utah Bank, Idaho Bank, Management Company, and Security Life were all wholly owned subsidiaries of Holding Company and under its control. We are concerned with allocation of income from Security Life to the two banks. That income consists of a portion of Security Life's share of premiums paid by borrowers from the banks and received by Security Life under its reinsurance treaties. The test to be applied is whether the banks' income with respect to the borrowers' purchase of credit insurance was other than it would have been had the banks in the conduct of their affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. *Davis* v. *United States*, 10 Cir., 282 F. 2d 623, 626. Application of that test to the facts presented is not easy.

The two banks are national banks. Section 92, 12 U.S.C., authorizes national banks located in a place having a population not to exceed 5,000 inhabitants to act as an insurance agent. In 1963, an administrative ruling by the Comptroller of the Currency purportedly authorized every national bank, regardless of where located, to enter the insurance agency field. That ruling was nullified by *Georgia Association of Independent Insurance Agents, Inc.* v. *Saxon*, N.D. Ga., 268 F. Supp. 236, affirmed 5 Cir., 399 F. 2d 1010, on the ground that, although § 92 does not explicitly prohibit banks in places with a population of over 5,000 from acting as insurance agents, it does so impliedly. In a different factual situation the Fourth Circuit held that a national bank is prohibited from

operating an insurance department except in towns of less than 5,000 inhabitants. See *Commissioner of Internal Revenue* v. *Morris Trust*, 4 Cir., 367 F. 2d 794, 795. We agree.

Section 93, 12 U.S.C., provides that for any violation of the chapter on national banks, the franchise of the banking association shall be forfeited and the directors individually shall be liable for damages sustained. The Tax Court found that because of the statutory provisions, and the advice of counsel relating thereto, the banks believed that it would be contrary to federal banking law to receive income resulting from their customers' purchase of credit insurance and they have never received commissions or reinsurance premiums arising from credit insurance transactions.

The Commissioner argues that the inhibitions of the banking laws do not preclude the operation of the tax laws. The banks concede the supremacy of the federal tax laws. Their position is that because of the prohibitions of the federal banking laws the banks have consciously remained aloof from any entitlement to income from the sale of insurance.

For the six years after the banks began offering credit insurance and before the formation of Security Life, the banks dealt exclusively with unrelated insurance companies in an uncontrolled situation. The Tax Court found that in the conduct of their affairs with these insurance companies the banks "never received or attempted to receive commissions or reinsurance premiums resulting from their customers' purchase of credit insurance." Conversely the Tax Court made no finding that if Security Life did not exist the banks would then receive or attempt to receive any such income. In an uncontrolled situation with arm's length dealing the banks, on the basis of

the findings made, would not have taxable income from the credit insurance transactions.

When all the underbrush is cut away, the theory of the Commissioner appears as a claim that the generation of the credit insurance business by the banks sustains the allocation of a portion of the premium income to them. He relies on *Local Finance Corporation* v. *Commissioner of Internal Revenue, supra*. We turn to that decision.

Local Finance presents a fact situation quite comparable to that confronting us. Commonly owned Indiana small loan companies offered credit insurance to their borrowers and about 90% of those borrowers took the insurance at the rate of $1.00 per year per $100 of coverage. For a part of the period the insurer paid a guaranteed commission of 40% of the net premiums, plus certain extras, to an officer of the finance companies who, upon receipt, assigned the amount to the parent company. Later, a controlled life insurance company was organized and it reinsured the risks. Indiana law forbade finance companies from receiving any income other than interest on loans. Each finance office had a licensed insurance agent. The Commissioner allocated a portion of both the commission income and the reinsurance income to the parent. The rationale of the Tax Court opinion in Local Finance is not clear. We believe that dissenting Judge Fay's analysis is correct. He said, 48 T.C. 773 at 802:

> The majority opinion also relies upon section 482 for support in allocating the income to petitioners in order to clearly reflect income. The premise of this approach is the previously reached conclusion that petitioners have earned the income by the performance of various serv-

ices and have exercised a power of disposition over this income to channel it to the reinsurance company.

In affirming the Tax Court, the Seventh Circuit said, 407 F. 2d 629 at 632 and 633:

> The commissioner's allocation had the effect of compensating the finance companies for their efforts in generating and processing the life insurance.
>
> * * * * *
>
> However little the finance companies did to earn this money, they performed those minimal services which were the *sine qua non* of the insurance business.

The Commissioner now urges on us the generation of business theory. He says in his brief that "the effect of the Commissioner's allocation is to compensate Utah Bank and Idaho Bank for their efforts in generating and processing the credit insurance."

Generation of income differs from assignment of income. It is fundamental that a taxpayer cannot assign a portion of his income in order to avoid tax liability on it. See *Lucas* v. *Earl,* 281 U.S. 111. Also the power to dispose of income is the equivalent of ownership. *Helvering* v. *Horst,* 311 U.S. 112, 118. These principles are grounded on rights in or flowing from income. See *Poe* v. *Seaborn,* 282 U.S. 101, 117.

The position of the Commissioner in effect is that whoever generates income must include the amount thereof in his gross income. The fallacy of this position was exposed by the Tax Court in *Teschner* v. *Commissioner of Internal Revenue,* 38 T.C. 1003, 1007, when it said:

> If this were the law, agents, conduits, fiduciaries, and others in a similar capacity would be personally taxable on the proceeds of their efforts. The charity fund-raiser would be tax-

> able on sums contributed as the result of his efforts. The employee would be taxable on income generated for his employer by his efforts. Such results, completely at variance with every accepted concept of Federal income taxation, demonstrate the fallacy of the premise.

See also *Basye* v. *United States,* N.D. Calif., 295 F. Supp. 1289, 1292–1295.

Indeed, the acceptance of the generation of business theory would have alarming consequences on normal commercial practices such as all types of referral business and security commission giveups. See *Seieroe* and *Gerber,* "Section 482—Still Growing at the Age of 50," 46 Taxes 893, 900–902 (Dec. 1968). We believe that in principle it runs contrary to all court and Tax Court decisions except Local Finance.

From the standpoint of principle the case at bar is indistinguishable from such cases as *Nichols Loan Corporation of Terre Haute* v. *Commissioner of Internal Revenue,* 21 T.C.M. 805, reversed on other grounds, 7 Cir., 321 F. 2d 905 (deduction by small loan companies of expenses attributable to credit insurance); *Campbell County State Bank, Inc., of Herreid, South Dakota* v. *Commissioner of Internal Revenue,* 37 T.C. 430, reversed on other grounds, 8 Cir., 311 F. 2d 374 (attribution of income and expenses of commonly owned insurance agency to bank); *L. E. Shunk Latex Products, Inc.* v. *Commissioner of Internal Revenue,* 18 T.C. 940 (allocation to manufacturer of part of income of controlled outlet when manufacturer was prohibited by maximum price regulations from receiving the income sought to be allocated); *Jaeger Motor Car Company* v. *Commissioner of Internal Revenue,* 17 T.C.M. 1098, 7 Cir., 284 F. 2d 127, cert. denied 365 U.S. 860 (anticipatory transfer of insurance income from agent to controlled company); *Moke Epstein,*

Inc. v. *Commissioner of Internal Revenue*, 29 T.C. 1005 (insurance commissions received by president of taxpayer); and *Ray Waits Motors, Inc.* v. *United States*, E.D. S.Car., 145 F. Supp. 269 (insurance commissions received by president of taxpayer).

Even though the credit insurance emanated from the banks in connection with their loan business, the result does not follow that the banks should be taxed for income which they neither earned nor received. They did not earn it because (1) they were not licensed insurance agents, (2) they were impliedly prohibited by federal law from operating an insurance business, (3) their participation required minimal effort and negligible cost compatible with the added protection which they secured for loan payment, and (4) they had no underwriting risk. True it is that they physically received the premium payments but in so doing they acted only as a conduit to pass them on intact to others who were legally entitled thereto.

Consideration of §§ 61 and 482 separately or in tandem does not change the result. The § 61 cases such as *Lucas* v. *Earl, supra,* and *Helvering* v. *Horst, supra,* are not pertinent because the banks neither assigned nor otherwise disposed of income. They simply had no income from the credit insurance business. We are unwilling to extend those decisions to situations where the taxpayer has the power to channel profitable business.

The test for allocations under § 482 is arm's length dealing with an uncontrolled taxpayer. As the Tax Court recognized, in arm's length dealings with independent insurers before the organization of Security Life the banks did not receive income from credit insurance premiums. In our opinion the change to the reinsurance arrangement with National and Secu-

rity Life did not change the situation so far as the income of the banks is concerned. They handled the business in the same way and were under the same inhibitions. The change in operations was for the benefit of Holding Company, not the banks.

We recognize the established rules that substance prevails over form, that the Commissioner has a wide discretion which we may not upset unless it is used arbitrarily or capriciously, and that the burden of persuasion lies on the taxpayers. These do not change the result. Generation of business is not enough to impose federal income tax liability. The effect of the action of the Commissioner and the decision of the Tax Court is to allocate approximately $800,000 in income to the banks and charge them with nearly $400,000 in tax deficiencies thereon. The banks have not received, and in all probability never can receive, the income because of the present diverse public ownership of the parent of the banks and the parent of Security Life. We believe that the § 482 allocations made by the Commissioner are arbitrary and capricious and inconsonant with the basic concepts of federal income taxation. To the extent that this opinion is inconsistent with that in Local Finance we respectfully disagree with that decision.

Because it upheld the Commissioner's allocations of income to the banks, the Tax Court rejected his alternative allocation to Management Company. Counsel for the Commissioner say that there is an adequate basis for the alternative allocation but we cannot answer that question on the record presented. It must be considered in the first instance by the Tax Court.

In Nos. 611–69 and 612–69 the judgments are severally reversed. In No. 613–69 the judgment is reversed and the case is remanded to the Tax Court for further consideration.

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APPENDIX C

No. 611-69

First Security Bank of Utah, N.A., petitioner-appellant

v.

Commissioner of Internal Revenue, respondent-appellee

No. 612-69

First Security Bank of Idaho, N.A., petitioner-appellant

v.

Commissioner of Internal Revenue, respondent-appellee

No. 613-69

First Security Company, petitioner-appellee

v.

Commissioner of Internal Revenue, respondent-appellant

Before Honorable Jean S. Breitenstein and Honorable Oliver Seth, Circuit Judges; and Honorable George Templar, District Judge.

January Term—January 21, 1971

These consolidated cases came on to be heard on the petitions for review from the United States Tax Court and were argued by counsel. On consideration whereof, it is ordered as follows:

1. In Cases Nos. 611–69 and 612–69 the decisions of the Tax Court are severally reversed.

2. In Case No. 613–69, the decision of the Tax Court is reversed and the case is remanded to the Tax Court for further consideration.

HOWARD K. PHILLIPS,
Clerk.

By HELEN R. BARTHA,
Deputy Clerk.

A true copy.
Teste.
Howard K. Phillips,
Clerk, U.S. Court of Appeals, Tenth Circuit.
By Helen R. Bartha,
Deputy Clerk.

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.* Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * * * *

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

Treasury Regulations on Income Tax (26 C.F.R.):

Sec. 1.482-1. *Allocation of income and deductions among taxpayers.*

(a) *Definitions.* When used in this section * * *

* * * * *

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.*—

(1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied

in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * * * *

(c) *Application.*—Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * * * *

Revised Statutes:

SEC. 5202 [as amended by Section 1, Act of September 7, 1916, c. 461, 39 Stat. 752]. * * *

* * * * *

That in addition to the powers now vested by law in national banking associations organized under the laws of the United States any such association located and doing business in any place the population of which does not exceed five thousand inhabitants, as shown by the last preceding decennial census, may, under such rules and regulations as may be prescribed by the Comptroller of the Currency, act as the agent for any fire, life, or other insurance company authorized by the authorities of the State in

which said bank is located to do business in said State, by soliciting and selling insurance and collecting premiums on policies issued by such company; and may receive for services so rendered such fees or commissions as may be agreed upon between the said association and the insurance company for which it may act as agent; and may also act as the broker or agent for others in making or procuring loans on real estate located within one hundred miles of the place in which said bank may be located, receiving for such services a reasonable fee or commission: *Provided, however,* That no such bank shall in any case guarantee either the principal or interest of any such loans or assume or guarantee the payment of any premium on insurance policies issued through its agency by its principal: *And provided further,* That the bank shall not guarantee the truth of any statement made by an assured in filing his application for insurance.

[12 U.S.C. (1946 ed.) 92.]*

SEC. 5239.

If the directors of any national banking association shall knowingly violate, or knowingly permit any of the officers, agents, or servants of the association to violate any of the provisions of this Title all the rights, privileges, and franchises of the association shall be thereby forfeited. Such violation shall, however, be de-

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*Because this provision was omitted from the 1918 amendment and reenactment of Section 5202 of the Revised Statutes by Section 20 of War Finance Corporation Act, c. 45, 40 Stat. 506, 512, the revisers of the United States Code have omitted it from editions of the Code, subsequent to the 1946 edition, on the theory that it was repealed in 1918. The implicit statutory proscription is, however, incorporated in the Comptroller of the Currency's current Regulations as 12 C.F.R. 2.1–2.5. See *Commissioner* v. *Morris Trust*, 367 F. 2d 794, 795 & n. 3 (C.A. 4); *Saxon* v. *Georgia Ass'n of Independent Ins. Agents*, 399 F. 2d 1010 (C.A. 5).

termined and ajudged by a proper district or Territorial court of the United States in a suit brought for that purpose by the Comptroller of the Currency, in his own name, before the association shall be declared dissolved. And in cases of such violation, every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other person, shall have sustained in consequence of such violation.

[12 U.S.C. 93.]

U.S. GOVERNMENT PRINTING OFFICE: 1971

No. 70-305

IN THE

Supreme Court of the United States

October Term, 1971

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

FIRST SECURITY BANK OF UTAH, N.A., et al.

On Writ of Certiorari to the United States
Court of Appeals for the Tenth Circuit

BRIEF FOR THE RESPONDENTS

S. J. Quinney
Alonzo W. Watson, Jr.
Stephen H. Anderson
Ray, Quinney & Nebeker
400 Deseret Building
Salt Lake City, Utah 84111
Counsel for Respondents

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-305

COMMISSIONER OF INTERNAL REVENUE,
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FIRST SECURITY BANK OF UTAH, N.A., et al.

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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BRIEF FOR THE RESPONDENTS

QUESTION PRESENTED

May the Commissioner, pursuant to Section 482 of the Internal Revenue Code, allocate to the taxpayer national banks insurance-related income which the Banks did not and could not receive due to prohibitions of the federal banking laws, thus resulting in a tax where there is no income?

STATEMENT

Respondents are Utah and Idaho national banks subject to the control of the Federal Reserve system, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency. They are subsidiaries of First Security Corporation (Holding Company), a publicly owned bank holding company—the oldest in existence.. In addition to the Banks,

the Holding Company had other (non-banking) subsidiaries, including First Security Life Insurance Company of Texas ("Security Life"—a life insurance company), Ed. D. Smith and Sons ("Smith"—a corporate insurance agency) and First Security Company ("Management Company"—a management company which provided management and accounting services to the group).[1] (R.164-166.)

Since 1948, the Banks have made available to their loan customers credit insurance, which will pay off the debt if the customer dies or becomes disabled. This was done to offer customers a service which competing lenders were increasingly supplying, to obtain additional collateral for the debt (in the form of insurance), and to obtain an additional source of income from part of the insurance premiums. (R.166.) The premium, \$1.00 per year per \$100.00 of insurance coverage, was the rate commonly charged in the industry and was approved by the insurance commissioners of Utah and Idaho. (R.166, 170.)

Contrary to implications in the Commissioner's brief (Br. 6, 8, 13, 17), the banks did not push the sale of insurance. They did not require their loan customers to take credit insurance and less than 50% of their installment loan customers and 13% of their mortgage loan customers subscribed. It was simply a minor part of the routine of the Bank's loan officers (who were not licensed insurance agents) to explain the function of credit insurance and, if

1. In September, 1959, pursuant to a reorganization to comply with the Bank Holding Company Act of 1956 (12 U.S.C. § 1841 et seq.), the Banks and the Management Company were placed in a newly organized bank holding company, whose stock was distributed to the stockholders of the old holding company, which retained the non-banking subsidiaries, including Security Life and the insurance agency. Thereafter, as a result of public trading, the stock ownership of the two holding companies became substantially different. (R. 165, 185.)

the customer wanted it, to take the application (consisting of just four lines), collect the premium, and give the customer his insurance certificate. The cost to the Banks for the actual time involved in explaining and processing the insurance was less than $2,000 per year, characterized by the courts below as "negligible."[2] The paperwork and bookkeeping involved in the Banks' credit insurance program were handled by the Management Company, which received the applications, duplicate certificates, and premiums from the Banks, kept records of the insurance written, forwarded premiums to the insurance company, and processed claims. The cost to the Management Company of processing credit insurance for both Banks was about $2,000 per year, also characterized by the courts below as "negligible". (R.169-170, 184.)

Prior to April, 1954, the Banks' credit insurance underwriters were unrelated insurance companies which paid commissions ranging from 40-55% of premiums to the Holding Company's insurance agency subsidiary, Ed. D. Smith and Sons, under agency agreements appointing Smith as their agent to write credit insurance. (R.166-167.)

Late in 1953, American National Insurance Company of Galveston, Texas approached the Holding Company with a plan under which it would act as the prime underwriter for the Banks' credit insurance, providing record keeping, insurance accounting, and actuarial services for a fee, and then reinsure all of the risks with an insurance subsidiary to be formed by the Holding Company, with the expectation

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2. Contrary to the Commissioner's assertions (Br. 6, 12-13, 28), in performing the incidental activities required to make credit insurance available to borrowers, the Banks' loan officers were agents of the customers and acting for the Banks' benefit; they were not agents of the insurance company. (R. 69.) *Boseman* v. *Connecticut General Life Insurance Co.*, 301 U.S. 196, 204-205.

that the reinsurance subsidiary would ultimately grow into a full-line, direct-writing insurance company. American National evolved this plan anticipating that sophisticated lending institutions would recognize that credit insurance was profitable and, sooner or later, would form their own insurance companies to underwrite the business.[3] At least, under the proposed plan, American National would recoup something, through the service fee, for its experience and facilities for handling credit insurance. (R.167-168.)

The Holding Company adopted American National's plan and, with the approval of the Texas Board of Insurance Commissioners, formed a new subsidiary, First Security Life Insurance Company of Texas, with an initial capital and paid-in surplus of $37,500 (later increased to $100,000).[4] In April, 1954, the Banks began placing their credit insurance with American National, which in turn reinsured all of the risks with—and remitted all of the premiums to—Security Life, under reinsurance treaties which allowed American National to keep 15% of net premiums for keeping First Security's books and records and computing its actuarial reserves. (R.168-169, 185.)

Although Security Life's credit insurance business was successful, there was no way to predict this at the outset; for, as the following table shows, Security Life insured a

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3. There were a variety of business reasons for forming Security Life. Moreover, there was also a possible tax advantage in taking the credit insurance profit in the form of insurance premium income (assuming a favorable loss experience), since only the investment income of a life insurance company was taxed. This potential advantage was largely eliminated in the Life Insurance Company Tax Act of 1959. (R. 133, 141, 168.)

4. Security Life was not rare or unusual. It is common practice in the insurance industry to begin an insurance company by reinsuring risks, to avoid large initial capital requirements. (R. 83, 169.)

large amount of risk in relationship to its capital structure (R.170-171):

Analysis of Risk Assumed By Security Life Insurance Company

Year	Number of policies reinsured	Amount of risk at year-end	Extra claims which would have eliminated surplus*
1954	12,500	$ 6,483,000	3
1955	27,594	13,360,000	9
1956	34,388	21,105,000	28
1957	29,591	25,570,000	28
1958	32,155	36,761,000	50
1959	36,416	41,350,000	97

* Assuming claims of $5,000 per policy, the maximum coverage under Security Life's policies.

Security Life was a relatively small company that was facing the possibility of high mortality claims because the Banks' customers could obtain credit insurance without medical examination or a waiting period and customers were concentrated in a limited geographical area which could be affected by a common disaster or disease. (R.172.)

The officers of the Holding Company and the Banks believed, on advice of counsel, that it would be a criminal violation of federal banking law for the Banks to receive any income from their customers' purchase of credit insurance. Consequently, the Banks never received—or attempted to receive—commissions or any other compensation from the credit insurance program. (R.172.) The Commissioner now accepts (Br. 29) the fact that the Banks' understanding of federal banking law prompted them to "structure their affairs so as to remain aloof from the receipt of insurance-related income."

In his statutory notices of deficiency, the Commissioner determined that all of the insurance premiums received by Security Life from 1955 through 1959 should have been reported by the Banks or, alternatively, by the Management Company, without citing any statutory authority. Two days before trial in the Tax Court, the Commissioner gave notice that he would rely on § 61 and § 482 of the Internal Revenue Code of 1954. During trial, the Commissioner abandoned his attempt to reallocate premium income attributable to mortgage, borrow-by-check and twin-dollar forms of credit insurance, leaving for the proposed reallocation only Security Life's installment loan credit life and disability insurance premiums. The Commissioner also urged, during trial, that only 40%—rather than all—of those premiums be taxed, alternatively, to the Banks or the Management Company. (R.172-173.)

Feeling that the result was dictated by the Tax Court's decision in *Local Finance Corporation* v. *Commissioner*, 48 T.C. 773, affirmed, 407 F.2d 629 (7th Cir.), certiorari denied, 396 U.S. 956, from which he had dissented, Judge Fay of the Tax Court approved the Commissioner's allocation of 40% of Security Life's net credit insurance premiums on installment loans for 1955 through 1959 (about $800,000) as income to the Banks and entered decisions determining income tax deficiencies, attributable to the additional income, aggregating about $400,000. (R.173-179.)

Rejecting the Commissioner's theory that the Banks should be taxed on First Security's premium income because they generated the insurance business and finding that the Commissioner's allocation under § 482 of the Internal Revenue Code was arbitrary, capricious, and inconsonant with basic concepts of federal income taxation because the Banks neither earned nor received nor could have *lawfully* received any income from the credit insurance program, the Tenth Circuit reversed the Tax Court's deter-

mination of deficiencies against the Banks and remanded the case involving the Commissioner's alternative allocation to the Management Company to the Tax Court for further factual consideration. The Tenth Circuit expressly noted—and disagreed with—the Seventh Circuit's decision in the *Local Finance* case. (R.182-192.)

SUMMARY OF ARGUMENT

I.

The underlying premise of Section 482—which permits the Commissioner to reallocate income between controlled entities—is the unfettered power of the controlling parties arbitrarily to understate the income of one entity in favor of another. Here, no power existed to understate the Banks' income by excluding insurance commissions, since federal banking law made it impossible for the Banks to receive insurance-related income under any circumstances.

Thus, the Commissioner has misconstrued and misapplied his own § 482 regulations by reclassifying reinsurance premium income as commission income and attributing it to National Banks which did not—and could not lawfully—receive it, regardless of the common control of the Banks and the Insurance Company by the Holding Company. In order to achieve that result, the Commissioner urges disregard of all applicable precedents and a novel interpretation of § 482 which would expand—and distort—the accepted definition of gross income in the tax laws.

II.

Through the years there have been many cases involving an attempt by the Commissioner, on one theory or another, to restructure transactions involving insurance-related income derived incidentally to banking, finance company, and automobile sales transactions. Such cases frequently involved state laws which inhibited any form of compensa-

tion, by commission or otherwise, to the business involved in the principal transaction.

With the exception of *Local Finance,* which generated four opinions in the Tax Court and which the court below considered and rejected, the courts have uniformly refused to accord the Commissioner the power to rearrange the transactions to exact the maximum tax by attributing income to one who could not lawfully receive it.

III.

Under the guise of reallocating gross income the Commissioner is really passing hindsight judgment on the rate structure of the credit insurance industry and the profit of Security Life, insisting that a life insurance company must always pay a certain amount of commissions and that the minimum effort required for the Banks to offer their loan customers a mutually beneficial service earned those commissions. This argument completely disregards the Record, which shows that the premium charged by the unrelated insurance company was the "going rate," there is no fixed commission element in insurance premiums, and Security Life took a great risk for the premiums it received, for which it was entitled to be compensated.

IV.

Notwithstanding the broad scope of Section 482, there is no power on the part of the Commissioner to create income in the hands of a taxpayer who did not—and could not—receive it because of legal prohibitions. A rule attributing illegal income and taxing such attributed illegal income would create an unthinkable dilemma between federal taxing and banking laws and produce the unconscionable result of exacting a tax where there could be no income and, hence, where no part of the money being taxed is available to discharge the tax liability.

ARGUMENT

I. SECTION 482 CANNOT BE USED TO TAX THE BANKS ON INCOME WHICH THEY DID NOT—AND COULD NOT LAWFULLY—RECEIVE.

A. The Commissioner Misconstrues His Own Regulations: § 482 Applies Only Where the Exercise of Common Control Has Resulted in Understating the True Taxable Income of One Entity in Favor of Another.

Section 482 authorizes the Commissioner to allocate income and deductions among commonly controlled business entities if he determines that such allocation is necessary in order to prevent "evasion of taxes or clearly to reflect the income" of any such entities. This provision, which first appeared in its present form in the Revenue Act of 1928, was designed—

> "* * * to prevent evasion (by the shifting of profits, the making of ficticious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability." H. Rep. No. 2, 70th Cong., p. 16 (1939-1 Pt. 2 Cum. Bull. 395).

The Commissioner mistakenly assumes (Br. 15-16) that there is no dispute between the parties over his statement that the test under §482 is whether the "arrangements" would not have been the same or whether the related parties "have not acted as they would have in identical, but uncontrolled, arm's length dealings." This statement is far broader than the statute—or the Commissioner's own regulations implementing the statute—warrants.[5] According to the regulations (set forth in Pet. Br. App. 37-38), the scope and purpose of §482 is—

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5. For a comprehensive current discussion of judicial developments with respect to § 482 see, Aland, *"Section 482—1971 Version"* 49 TAXES 815 (Dec. 1971).

"* * * to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer." Regs. §1.482-1 (b)(1).

The premise underlying the statute is that—

"The interests controlling a group of controlled taxpayers are *assumed* to have *complete power* to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers." Regs. § 1.482-1(b)(1). (Emphasis supplied.)

The key to §482, therefore, is the existence of power to cause "the arbitrary shifting of profits among related business entities." See S. Rep. No. 275, 67th Cong., Ist Sess. (1921), 1939-1 Cum. Bull. (Pt. 2) 181, 195 discussing § 240 of the Revenue Act of 1921—the predecessor of § 482. It is only where the power exists—and has been exercised in such a way that the taxable income of a controlled entity has been "understated"—that the Commissioner is authorized to reallocate. Regs. §1.482-1(b)(1). Stated differently, the Commissioner may not allocate income in ways that the controlling interests did not themselves have the power to accomplish.

The *test* for determining whether an allocation is authorized under Section 482 because the power exists and has been exercised to shift (and therefore understate) income is whether—

"* * * the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an un-

controlled taxpayer, dealing at arm's length with another uncontrolled taxpayer." Regs. §1.482-1(c).

The Tenth Circuit explicitly adopted that test (R.187) and the Commissioner does not directly repudiate the test here. He does, however, attempt to change the focus of the statute by urging that the test is whether the "arrangement" would have been different absent the controlled relationship. (Br. 15, 16.) Section 482, its legislative history, and the Regulations clearly indicate that the only pertinent inquiry is whether the Banks' income was "understated" by reason of the common control of the Banks and Security Life and whether the Banks' income would have been any different in an uncontrolled situation. These are the questions which must be answered.

B. The Commissioner Has Misapplied His Own Regulations: The Holding Company's Control Over the Banks and Security Life Did Not Result In Understating the Banks' Income.

National banks in towns over 5,000 population are prohibited from receiving insurance commissions. Rev. Stats. §5202 (12 U.S.C. (1946 ed.) 92; Pet. Br. App. 39).[6] Penalties for violating that federal law are severe: Forfeiture of the bank's charter and personal liability on the part of the Directors. Rev. Stats. § 5239 (12 U.S.C. 93; Pet. Br. App. 40).

The Commissioner now acknowledges that it was the Banks' understanding of this statute that "prompted them

6. While the Commissioner raises some question whether § 5202 remains in force, he acknowledges that the Comptroller of the Currency's current regulations incorporate that proscription and that the Courts have invalidated a 1963 ruling of a prior Comptroller to the contrary. (Pet. Br. 28, n. 14.)

to structure their affairs so as to remain aloof from the receipt of insurance-related income". (Br. 29.)

Due to the federal banking law, the fundamental prerequisite of §482 is absent in this case: The Holding Company did not have "complete power" to cause the Banks to take commissions, and thus lacked the power arbitrarily to shift any such income away from the Banks.

In the leading case dealing with the application of § 482 to a situation where the controlled entity was prohibited by law from receiving the income sought to be allocated, the Tax Court squarely held that the Commissioner could not allocate income which could not lawfully be received.

In *L.E. Shunk Latex Products, Inc.* v. *Commissioner,* 18 T.C. 940, a classic § 482 situation,[7] the same interests controlled a manufacturer and a distributor of rubber prophylactics. During the sharply rising market following Pearl Harbor, the distributor raised its prices to retailers, but the manufacturer failed to raise its prices to its related distributor. Shortly thereafter, an OPA regulation froze the manufacturer's price as of December 1, 1941, so that it could not have *lawfully* charged more—either to its own or an unrelated distributor. The Court held that the OPA regulation had the effect of—

> "* * * prohibiting petitioners from *receiving* the very income sought to be attributed to them. We think that the Commissioner had no authority to attribute to peti-

7. In contrast to *Shunk* and many other § 482 cases, this case does not involve a closely held corporation situation where director-officer-owners stand to enrich themselves through corporate devices. The Banks are publicly owned through the Holding Company, with independent businessmen from many segments of industry as directors. (R. 17, 21.)

tioners income which they *could not have received.*" (18 T.C. at 961.) (Emphasis supplied.)[8]

Moreover, the Commissioner himself has recognized, in other contexts, that legal prohibitions against the receipt of income will preclude the application of § 482. On October 8, 1971, the Commissioner issued Technical Information Release No. 1106, with respect to the current wage-price freeze, stating that taxpayers who accumulate earnings in excess of the reasonable needs of their business will not be subject to the accumulated earnings penalty tax of § 531 of the Code, to the extent that the excess accumulation could not be distributed as a dividend without violating the Cost of Living Council's Guidelines. And in § 482-1(d)(6) of the Regulations, the Commissioner states that no tax will be imposed on a domestic parent as a result of a § 482 allocation if the parent is unable to receive the allocated income

8. The Commissioner (Br. 33) attempts to distinguish *Shunk* on the ground that the taxpayer could not raise its price since it was fixed by law ("*de jure*"). But the taxpayer certainly could have raised its price—it would simply have violated the law by so doing. The same is true here: The Banks could have taken commissions if they had been willing to violate the law. The Court's statement in *Shunk* that the Commissioner *may not "attribute to petitioners income which they could not have received"* (emphasis supplied), does not mean that the taxpayer could not physically have received the money in violation of the law, since it obviously could. It means that when taxpayers in good faith structure their affairs in compliance with a law which vitiates the controlling taxpayer's power to shift income, the Commissioner may not (1) force them into an unlawful act by virtue of an artificial allocation, or (2) by such an allocation, exact a tax where there can never be any income.

due to legal prohibitions of the foreign country of the subsidiary.[9]

Thus, where the interests controlling a related group do not have the legal power to cause the taxpayer in question to receive the income sought to be allocated, it is the legal prohibition—and *not the control element*—which is responsible for any conceivable economic understatement of income; hence, there is nothing on which § 482 can operate. So here, because of the legal prohibition in the federal banking laws, the Banks' income would not have been greater regardless of the control element.

Both courts below found that the banks "* * * never received or attempted to receive commissions or reinsurance premiums resulting from their customers' purchase of credit insurance."[10] (R.172, 188.) Conversely, as pointed out by the Court of Appeals—

> "* * * the Tax Court made no finding that if Security Life did *not* exist the Banks would then receive or attempt to receive any such income." (R.188.) (Emphasis supplied.)

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9. In this case, the Commissioner's allocation would result in imposing a tax on the Banks, although they could never obtain the income which gave rise to the tax from Security Life, which, in 1959, became a subsidiary of an unrelated corporation. That separation renders ineffective the correlative adjustment reducing Security Life's income, suggested by the Commissioner. (Br. 8, n. 3.)

10. The Commissioner's comment that lack of "receipt" of money is irrelevant to the application of § 482 (Br. 22), completely misses the point made by the Tenth Circuit that due to prohibitions of federal banking law, the Banks had *no power* to receive the income. Conversely, since the banks had never taken insurance-related income illegally, the Commissioner's citation of cases taxing income actually, though illegally, received is irrelevant. (Pet. Br. 29-30.)

The Court of Appeals concluded that—

> "In an uncontrolled situation with arm's length dealing, the Banks, on the basis of the findings made, would not have taxable income from the credit insurance transactions." (R.188.)

These findings by the Courts below are buttressed by the fact that for six years *prior* to the formation of Security Life, the Banks (due to federal law) did not receive any income from the purchase of credit life insurance by their loan customers. (R.188.)

The fatal underlying weakness of the Commissioner's brief is his refusal to accept those facts. His entire argument is premised upon the false and unsupported assumption that the Banks would unlawfully take insurance commissions in an uncontrolled situation (e.g., Br. 19-20, 23-24, 25, 31, 34). Such a premise erroneously assumes that the directors of the Banks would break the law.

The Commissioner, lacking any factual support for his position, resorts to a novel legal definition of the word "income" as used in § 482.

C. The Banks Realized No Income As that Term is Used in the Tax Laws.

For the first time in this litigation, and, to our knowledge, in any court anywhere (including *Local Finance*), the Commissioner is urging a definition of "income" under § 482 larger in concept and scope than the same word when used anywhere else in the Internal Revenue Code and Regulations. (Br. 23.) Only through this approach can he sustain his argument that, although the Banks did not—and cannot ever—receive any income, they must have received some theoretical income which the Commissioner may now allocate and upon which he proposes to charge a very real tax to the Banks.

There is no indication in the legislative history of § 482 that Congress intended to redefine gross income, as used in that Section. Section 482 only authorizes the Commissioner to allocate "gross income"—a term that is defined in § 61. Moreover, the thrust of § 482 is merely to determine the same taxable income for a controlled taxpayer as he would have had if uncontrolled. Regs. § 1.482-1 (a) (6), (b) (1), and (c). All roads, therefore, lead back to the concept of income as it has evolved through the interpretation of § 61.[11]

It is not hard to see why the Commissioner now wishes to redefine income altogether and avoid the § 61 guidelines and concepts of income developed by this and other courts over the years, which are wholly incompatible with the result the Commissioner is urging here.

As this Court said in *Commissioner* v. *Glenshaw Glass Co.,* 348 U.S. 426, 431, income has been held to encompass all—

> "* * * accessions to wealth, *clearly realized,* and over which the taxpayers have *complete* dominion." (Emphasis supplied.)

This concept fits together with the elements of "volition" or voluntary conduct, and the existence in the taxpayer of alternatives, as developed in such cases as *Helvering* v. *Horst,* 311 U.S. 112, *Corliss* v. *Bowers,* 281 U.S. 376, and

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11. To hold that § 482 is but a specific application of the income principles of § 61 in a controlled entity situation would not make § 482 superfluous, as the Commissioner suggests. (Br. 23.) It is well established that the Commissioner's determination under § 482 is entitled to such great weight that it cannot be overturned unless arbitrary and capricious—a much greater burden than in the ordinary deficiency case, where the Commissioner's determination is merely prima facie evidence. See *Grenada Industries, Inc.* v. *Commissioner,* 17 T.C. 231, affirmed 202 F.2d 873 (5th Cir.), certiorari denied, 346 U.S. 819. Other reasons are stated by the Second Circuit in *Rubin* v. *Commissioner,* 429 F.2d 650, 653-654.

Harrison v. *Schaffner,* 312 U.S. 579. The concept is expressed in *Corliss* v. *Bowers, supra,* at 378, where Mr. Justice Holmes remarked for the Court:

> "* * * income that is subject to a man's *unfettered* command and that he is *free to enjoy* at his *own option* may be taxed to him as his income, whether he sees fit to enjoy it or not." (Emphasis supplied.)

No decision of this Court deviates from the concept that before there is income the taxpayer must have the alternative, *at his option,* of either taking the income for himself or diverting it to someone else. Voluntary conduct based on the existence of alternatives is the very heart of that concept. Conversely, this Court has *never* held that a person may be taxed on income which he could not ever have received.

In this case, the Banks had no option. There was no question of voluntary conduct with respect to alternatives in electing to receive or not receive the income in question. This is the answer to the Commissioner's argument (Br. 19) that the Banks must be taxed because their minimal services were the *sine qua non* of the credit insurance business.

Taxation has never been predicated solely upon whether a person performs activities constituting the *sine qua non* of income (such as employees, trustees, parents' investment decisions for children, etc.). The touchstone has been the existence in the taxpayer of an "unfettered command" over the income—the right to enjoy it at his own option. *Corliss* v. *Bowers, supra; Commissioner* v. *Glenshaw Glass, supra.*

The result of the Commissioner's novel theory would be to substitute the subjective judgment of the tax administrator (as to whose effort produced what, and the quantum and "value" of effort measured against resulting income,

etc.) for clearly recognized standards—creating a tax concept virtually impossible to administer. It would also create a climate of uncertainty for taxpayers and their advisors.

One of the reasons why the *sine qua non* of business, alone, will not subject the generating party to a tax on all succeeding profit is that the generating party often will initiate the transaction in question for reasons unrelated to such profit. For example, in this case, making credit insurance available to borrowers contained its own built-in rewards to the Banks quite apart from the profit which preoccupies the Commissioner. George Eccles, President of the Banks, testified that credit life, health and accident insurance on borrowers was beneficial to the Banks as security for their loans. (R. 57.) No truer statement was ever made. During the years in suit such insurance paid off more than $500,000 in bank loans on death claims alone, against a negligible processing cost of only $2,000 per year per Bank. (R. 184.)

On similar facts, the Court of Appeals for the Seventh Circuit stated:

> "This Court should be slow to override the business judgment of petitioners that lending their facilities to the credit insurance business was beneficial." *Nichols Loan Corp.* v. *Commissioner*, 321 F.2d 905, 907.

The fact that *de minimis* amounts of time and expense were involved in the insurance paperwork in question, plus the fact that insurance was merely a minor incident to the Banks' major business of making loans, is also significant. In making the point that insurance was simply an incident to the main purpose of the business, the court in *Ray Waits Motors, Inc.* v. *United States*, 145 F. Supp. 269, 271, 272 (E.D. S. Car.), refused to allocate insurance income

to a car dealership, saying that the actions of the salesmen in asking customers about insurance were—

> "* * * *merely perfunctory duties connected with the main object*, which was the sale of the motor vehicle.
>
> * * *
>
> "The place of business of the plaintiff corporation was operated *primarily for the sale and repair of motor vehicles and not for the sale of insurance*." (Emphasis supplied.)

Even in circumstances where very substantial services were rendered, the Courts have rejected the Commissioner's *sine qua non* theory of income. In *Teschner* v. *Commissioner*, 38 T.C. 1003 (1962), the Tax Court refused to tax a father who, disqualified by contest rules from receiving a prize, submitted a winning entry in his daughter's name. The Court stated (38 T.C. at 1007, 1009):

> "Such results, completely at variance with every accepted concept of Federal income taxation, demonstrate the fallacy of the premise.
>
> * * *
>
> "Where an individual neither receives nor has the right to receive income, he is not the taxable individual within the contemplation of the statute. There is no basis in the statute or in the decided cases for a construction at variance with this fundamental rule."

See also *Basye* v. *United States* (9th Cir.), decided September 16, 1971, unofficially reported at 71-2 U.S.T.C. ¶ 9648, p. 87,552, affirming 295 F. Supp. 1289 (N.D. Calif.); and, Sieroe and Gerber, *"Section 482—Still Growing At the Age of 50"*, 46 Taxes 895, 900-902 (Dec. 1968), referring to the Commissioner's theory in this case as ". . . having truly frightening implications".

II. LOCAL FINANCE CONFLICTS WITH ALL APPLICABLE PRECEDENTS

Over the years, corporations such as banks, finance companies, and automobile dealers, precluded by state law from receiving compensation from the sale of insurance to their customers, have devised different methods of handling their affairs so as to allow related parties to profit where they themselves could not. Using as his pivotal argument the fact that employees of these businesses sold the insurance and handled the necessary paper work, the Commissioner has tried every weapon in his arsenal to restructure these transactions. Until the decision in *Local Finance Corp.* v. *Commissioner,* 48 T.C. 773, affirmed, 407 F.2d 629 (7th Cir.), certiorari denied, 396 U.S. 956, the lower courts have rebuffed the Commissioner at every turn, recognizing the problem posed by state law and the right of taxpayers to structure their business affairs as they choose,[12] regardless of tax savings.[13]

The most common arrangement was for the individual owners of the corporation to take out an insurance agency license and receive insurance commissions personally. The courts readily accepted such arrangements where the presidents and principal shareholders of family automobile businesses acted as casualty insurance agents—even though the actual work may have been done by the employees of the corporation without additional compensation. *Ray Waits Motors, Inc.* v. *United States,* 145 F. Supp. 269 (E.D. S. Car.); *Moke Epstein, Inc.* v. *Commissioner,* 29 T.C. 1005; *Gaddy Motor Company, Inc.* v. *Commissioner,* T.C. Memo. 1958-189 (17 T.C.M. 944); *Jaeger Motor Car Co.* v. *Commissioner, T.C. Memo.* 1958-223 (17 T.C.M. 1098), affirmed, 284 F.2d 127 (7th Cir.), certiorari denied, 365 U.S. 860.

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12. *Moline Properties, Inc.* v. *Commissioner,* 319 U.S. 436; *National Carbide Corp* v. *Commissioner,* 336 U.S. 422.

13. *Gregory* v. *Helvering,* 293 U.S. 465.

Similarly, in the field of credit life insurance such individual or partnership insurance agencies have been upheld and no attribution of commission income to the related financial institutions has been permitted, despite various arguments that, under Section 61 of the Code, the insurance agencies should be disregarded as a "sham," that the income was really earned by the corporation whose employees sold and serviced the insurance, and that Section 482 authorized a reallocation of income. *Campbell County State Bank, Inc.* v. *Commissioner*, 37 T.C. 430, reversed, on other grounds, 311 F.2d 374 (8th Cir.); *Paramount Finance Co.* v. *United States*, 304 F.2d 460 (Ct. Cl.); *Bank of Kimball* v. *United States*, 200 F. Supp. 638 (S.D.); *Nichols Loan Corp.* v. *Commissioner*, T.C. Memo. 1962-149 (21 T.C.M. 805), reversed on other grounds, 321 F.2d 905 (7th Cir.); *First Security Bank* v. *United States*, 213 F. Supp. 862 (Mont.), affirmed, 334 F.2d 120 (9th Cir.); *First State Bank* v. *United States*, (D.C. S.D., decided June 25, 1962; unofficially reported at 62-2 U.S.T.C. ¶ 9613).

Another type of transaction, developed subsequently, was to eliminate the insurance agency "middle man" and form a separate insurance company to arrange with the unrelated insurance carrier for reinsurance of the mortality risk. Although this meant giving up guaranteed commissions, there was a possibility of a greater profit through the assumption of an underwriting risk. In *Alinco Life Insurance Company* v. *United States*, 373 F.2d 336 (Ct. Cl.), the Commissioner attacked this arrangement, contending that, under Section 269, the reinsurance company was not entitled to be taxed as a life insurance company under Section 801 *et seq.* of the Code because it had been formed primarily to avoid taxes by securing the benefit of life insurance status. The Court of Claims, however, held that it was not tax avoidance to structure business affairs in response to the requirements of state law and that there could be no objection to arranging one's

affairs to take advantage of the treatment afforded to life insurers by the Code.

In *Local Finance,* which generated four separate opinions in the Tax Court, all of these precedents were swept aside. Judge Fay, dissenting, stated (48 T.C. at 803):

> "It is particularly noteworthy in this context to consider the past history of respondent's attempts to attack various business-connected insurance arrangements. Respondent has pitched his arguments on sections 61, 269, 482, and a general argument that income was properly taxable to a lending institution rather than a controlled reinsurer or the shareholders of the lending institution as partners of an insurance agency. All these approaches have been repeatedly rejected by this and other Courts."

Unable to distinguish the facts in *Local Finance* from the Tax Court's earlier decisions, Judge Fay remarked on the court's inconsistency (48 T.C. at 802):

> "* * * I am left with the curious result that where employees of lending institutions perform services regarding credit life insurance the stockholders of those institutions may validly take a profit from the insurance business by setting up a partnership to receive it but may not validly take, in effect, the same profit by setting up a legitimate insurance company to reinsure the risk."

Throughout this entire litigation the Commissioner has refused to face up to the fact that not one of the cases just cited could have been decided as they were under an application of the Commissioner's theory urged upon this Court. The Court of Appeals recognized that fact, pointing out that this case is indistinguishable in principle from those cases. (R. 190.)

The Tenth Circuit's opinion in this case is in accord with the applicable precedents, making *Local Finance* the sole aberration in a long line of cases refusing to tax institutions, whose business contact with customers provided an incidental opportunity to offer insurance, on income which they did not receive.

III. THE COMMISSIONER, UNDER THE GUISE OF ALLOCATING INCOME, DOES NOT HAVE THE POWER TO RESTRUCTURE BONA FIDE BUSINESS TRANSACTIONS.

A recurring theme of the Commissioner's brief is that 40% of the credit insurance premiums received by Security Life belonged to the Banks as commissions and did not constitute true income to which Security Life was entitled as compensation for reinsuring risks. Implicit in this argument are several unsupported and erroneous propositions: that the premium rate was excessive, that life insurance companies must always pay commissions, that commissions are a fixed element of the premium rate, that Security Life made excessive profits, and that taxes were improperly avoided. The Commissioner then arrogates to himself the right to determine, on hindsight, how much of Security Life's credit insurance premium income represented excess profit to be classified and disgorged as commission income to the Banks, purportedly to compensate them for offering insurance to their customers incidental to loan transactions.

Factually, however, the record shows: that the premium charged to the Banks' customers was the prevailing rate approved by the insurance commissioners[14] (R.68, 104, 170),

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14. The Commissioner's reference (Br. 20) to the legislative history of the Life Insurance Company Tax Act of 1955 is misplaced. The committee reports stated the belief that § 482 would come into play where a finance company had a credit life insurance subsidiary only when "the subsidiary charges excessive premium"—"higher than the going rate"—and the finance company's interest rate was correlatively reduced. S. Rep. No. 1571, 84th Cong., 2d Sess., 1956-1 Cum. Bull. 967, 971-972); Committee on Ways and Means, Taxation of Life Insurance Companies, Report By The Subcommittee on Taxation of Life Insurance Companies (1955, 83d Cong., 2d Sess. (Subcommittee Print)), p. 46. This refers to what would be a classic § 482 situation, namely, where the insurance premium was excessive and the interest rate was correlatively reduced. Here, the premium was not excessive (it was the "going" rate) and there was no "milking" of the Banks' interest income.

that there is no fixed amount of any premium which is set aside for the payment of commissions (R.84-85), that it was only "fairly common" (certainly not universal) for lending institutions to ask for compensation for offering insurance to their customers (R.105), and that the cost to the Banks of handling credit insurance, incidental to the principal loan transactions, was minimal and was a service required by competition and worthwhile to the Banks (R.166, 169): see also *Nichols Loan Corp.* v. *Commissioner, supra,* where because of the minimal cost and commensurate benefits to the finance companies, the court refused to disallow a deduction to the finance companies for the cost of selling and servicing credit insurance, even though commissions were paid to a related insurance agency.

One of the reasons why the Commissioner has fallen into these factual errors is that he fails to separate the function of insuring risks from the business of selling insurance. The business structure involving a guaranteed commission payable to Smith, on which the Commissioner relies so heavily, was quite different from the underwriting venture of Security Life—and Security Life was entitled to be compensated for its great risk. (R.83.) As the Court of Claims commented in *Alinco Life Insurance Co.* v. *United States,* (373 F.2d at 345):

> "* * * what [the finance companies] really did in this case was to give up guaranteed commissions in return for the possibility of a greater profit through the assumption of an underwriting risk."

And as Judge Drennan said, dissenting from the majority opinion in *Local Finance* in the Tax Court (48 T.C. at 799):

> "If the premiums chargeable and charged for this type insurance were more than adequate to cover the cost of writing it and the risk involved, I do not believe either the Commissioner or this Court should attempt to allocate the excess to the cost of performing the services of writing the insurance rather than to the risk involved, which [the reinsurance company] assumed."

The Commissioner completely ignores the magnitude and significance of the risk assumed by Security Life, which grew from $6,483 at the end of 1954 to $41,350,000 at the end of 1959. (R.171.) The evidence in this case, offered primarily through two expert witnesses who testified without challenge by the Commissioner on cross-examination, is that the size and nature of the risks assumed by Security Life required it to retain every dollar it received. (R.33, 85-86, 94, 100, 147-153, 171.) The Commissioner's submission to the contrary (Br. 5, 18) is based upon the testimony of Clarence Tookey, and averages derived by hindsight from the lump sum result of six years' operation.

On cross-examination, Mr. Tookey, after prodding by the trial judge, admitted that his experience in the credit insurance industry was limited to three companies: two in which he appeared as a witness for the Government, and one client. (R.113-115.) He also admitted (1) that he had not consulted publications or been in contact with representatives of the credit insurance industry (R.123); (2) that he used figures from outdated reports which had very little useful purpose (R.113, 115), although he had current reports in his possession (R.125. See R.91, 95-97); (3) that he had no idea what rates he would have considered safe in 1954 (R.116); and (4) that he had not studied the business of Security Life (R.109-110).

By averaging, the Commissioner avoids the rising trend of losses suffered by the Company (the Company's annual statements (Ex. B0-40) show losses of 37% in 1959 (compared to 20% in 1955), and lumps accident and health insurance lines with life insurance, thus avoiding the fact that by 1959 losses on accident and health insurance were in excess of 50% of premiums (Ex. B0-40).[15] Depriving his hindsight

15. By 1964, American National's losses on *all* lines of credit insurance in the state of Utah were 50% of premiums.

six year "profit" figure of averaging and lumping, the Commissioner's allocation theory would result in a 1.4% profit to Security Life on credit life insurance in 1959, and a *loss* of 11.6 cents on each credit accident and health premium dollar (R.170-171, Ex. B0-40). Stated another way, the Commissioner's theory would allow Security Life a profit of $5,075 for reinsuring $6,483,000 of risk covering 12,500 policyholders in 1954 (less than one-tenth of one percent profit on risks assumed); a profit of $48,300 for carrying $13,360,000 in insurance risk on 27,594 policyholders in 1955; $43,703 profit on $21,105,000 of risk on 34,388 policyholders in 1966, and so on. (R.170-171, Ex. B0-40.) Such profits are *not* reasonable when, on a prospective rather than hindsight basis, just a few extra deaths out of thousands of shareholders would have entirely eliminated any profit at all each year. In fact, the Commissioner's theory that Security Life had excessive profits was so untenable that just prior to trial he decided to eliminate from his proposed allocation premiums on mortgage, borrow-by-check, and twin dollar credit insurance, all of which experienced high losses. (R.125, Exs. B0-40, BZ-51.)

On these facts, the question must be asked whether there is any legal basis for the Commissioner to use specious hindsight analysis to transform $800,000 of Security Life's premium income (subject to insurance risk and reserve requirements when received) into commission income and claim that it merely represents compensation for services which cost each Bank less than $2,000 annually to perform.

The Commissioner's sole reliance is on a novel interpretation of § 482, which, if adopted, would give him protean power to restructure bona fide arrangements made by an affiliated group to comply with regulatory laws, so as to

exact the maximum possible tax from the group as a whole.[16] But § 482 will not stretch that far: Its focus is not on the arrangements which related taxpayers may make, but on the *results* of those arrangements, to avoid the arbitrary understatement of the income of one controlled entity in favor of another. Here, since the Banks were prohibited by law from taking insurance income, there was no understatement of the Banks' income to bring § 482 into play and the Commissioner cites no other law which authorizes him retroactively to restructure the arrangement.[17]

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16. Certain statements in the Commissioner's brief suggest that he misunderstands the purpose and history of § 482 and would like to tax the Holding Company and its subsidiaries on a consolidated return basis: For example, he refers to the proliferation of entities used to conduct what is basically a "single economic enterprise" (Br. 13); and he scores the reinsurance arrangement under attack as resulting "in a smaller total tax liability for Holding Company and its subsidiaries." (Br. 7, 27.) But the Banks and the Insurance Company performed entirely different functions and are not a "single economic enterprise;" and, in any event, the Commissioner's own regulations emphasize that § 482 is not intended to "produce a result equivalent to a computation of consolidated taxable income * * *." Reg. § 1.482-1(b)(3)

17. Although the Commissioner makes a passing reference to the tax evasion phrase of §482, and tax savings accorded life insurance companies until 1959 (Br. 4, 7, 34), he nowhere undertakes to argue that his proposed allocation of income is supported by that element of the statute. And neither court below made any such finding. In his discussion of *Campbell County State Bank, Inc.* v. *Commissioner, supra,* the Commissioner concedes (as pointed out by the Tax Court in *Campbell,* 37 T.C., at 438-439), that compliance with the law is a business purpose, not a tax saving purpose (Br. 33) and in effect admits that tax avoidance motives were not control factors here (Br. 31, n. 15). More recently, the Court of Appeals for the Fourth Circuit found that compliance by a national bank with the federal banking law involved in this case constituted a business, not a tax motive. *Mary Archer Morris Trust, North Carolina National Bank Trustee* v. *Commissioner,* 367

Indeed, his attempt to do so, runs squarely counter to all of the applicable precedents (except *Local Finance*) and to the maxim, as well entrenched in tax law as any the Commissioner cites, that a taxpayer is free to structure his affairs in any form, to comply with applicable laws, regardless of whether it results in a tax saving. See the decisions of this Court cited in notes 12 and 13; *Stearns Magnetic Mfg. Co.* v. *Commissioner,* 208 F.2d 849, 852 (7th Cir.); and *Seminole Flavor Co.* v. *Commissioner,* 4 T.C. 1215, 1235. The Commissioner should not be allowed to use a distorted view of his powers under § 482 to restructure business transactions in accordance with his hindsight view of what the profit and loss of each entity should have been and what tax they should have paid, on a consolidated basis.

F.2d 794, 795, 799. Of course, as shown by the tax returns of the entities involved, for the six years prior to the formation of Security Life, commissions paid to Smith were taxed in the highest corporate bracket (R. 20). Obviously during that time, the Banks' motive in remaining entirely aloof from insurance commissions was not tax avoidance but, as found by the courts below and now admitted by the Commissioner, to comply with federal law (R. 172, 187, Br. 29).

IV. THE COMMISSIONER'S POSITION TRAPS THE BANKS BETWEEN CONFLICTING FEDERAL LAWS AND CREATES AN UNREASONABLE DILEMMA.

The Commissioner wants this Court to allow him to allocate, on paper, a theoretical $800,000 from Security Life to the Banks, notwithstanding the fact that the Banks cannot receive that income due to prohibitions of the federal banking laws. The result will be to tax the Banks $400,000 for years in suit (and probably in excess of a million dollars for the years 1959 to the present) on nonexistent income—a truly absurd and incredible application of the tax laws. Moreover, such a result would have a detrimental effect on the financial condition of these national banks.

The Commissioner argues that the fault of the unthinkable predicament created by his theory in this case is not really his since *he*, "never forced" the Banks to have credit insurance available on their premises and, at any rate, all the Banks had to do was lower the premium rate so that it did not include money for commissions. (Br. 31-32.) That argument lacks support from the Record, warps the facts of this case and commercial reality beyond recognition, and asks this Court to make the Commissioner a regulatory agency over the banking and insurance industries. The Banks do not set the premium rates. They have no control over them whatsoever. (R. 68-69.) And even if the Banks could dictate rates to independent insurance companies, such as American National, the uncontradicted evidence is that there is no such thing as a fixed commission element in any premium rate. (R. 37.) A rate could be fixed so low that the insurance company operated at a loss and the company could still choose to pay commissions. Thus, the only way "commissions" could be "eliminated" from premium rates would be for the Commissioner to determine and promulgate his notion of what such an amount would be each year for each company.

The Commissioner's theory thus traps the Banks in a conflict between federal laws, leaving the Banks with the unreasonable alternatives of (1) paying taxes on income which they never have and never can receive; (2) breaking the law and attempting to receive such income from 1972 on, resulting in the loss of their bank franchise and personal liability imposed on their directors; (3) discontinuing insurance for their customers entirely, thus stripping the Banks of loan protection and other customer benefits; or (4) foregoing the opportunity of enabling a related entity, not forbidden by law, from realizing an economic benefit which the Banks could not take.

The unconscionable result of the Commissioner's tax on nonexistent income in this case—the impossible dilemma in which it places the Banks—falls within the language of this Court in *Farmer's Loan & Trust Co.* v. *Minnesota,* 280 U.S. 204, 212:

> "Taxation is an intensely practical matter and laws in respect of it should be construed and applied with a view of avoiding, so far as possible, unjust and oppressive consequences."

CONCLUSION

Our tax laws do not countenance a theory—such as that now urged upon this Court by the Commissioner—which would result in exacting a tax where there *never* could be any income to the taxpayer.

The decision of the Court of Appeals should be affirmed.

Respectfully submitted,

S. J. Quinney
Alonzo W. Watson, Jr.
Stephen H. Anderson
Ray, Quinney & Nebeker
400 Deseret Building
Salt Lake City, Utah 84111

Counsel for Respondents

CERTIFICATE OF SERVICE

I, STEPHEN H. ANDERSON, hereby certify that three copies of the foregoing Brief for the Respondents, First Security Bank of Utah, N.A., et al, were air mailed by me by depositing the same in a United States Post Office, postage prepaid, pursuant to paragraphs 2 and 3, Rule 33 of the Rules of the Supreme Court of the United States, to ERWIN N. GRISWOLD, Solicitor General, Department of Justice, Washington, D.C. 20530, this 29th day of December, 1971, and that all parties required to be served have been served.

STEPHEN H. ANDERSON
Counsel for Respondents

No. 70-305

In the Supreme Court of the United States

OCTOBER TERM, 1971

COMMISSIONER OF INTERNAL REVENUE, PETITIONER
v.
FIRST SECURITY BANK OF UTAH, N.A., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

ERWIN N. GRISWOLD,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

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REPLY BRIEF FOR THE PETITIONER

One point made in respondents' brief requires a short reply.

Respondents refer (Br. 2, n. 1) to a 1959 Reorganization as a result of which respondents and Security Life became owned by separate, publicly-held corporations. Respondents suggest (Br. 14, n. 9) that, by virtue of the subsequently developing difference in ownership of the two corporate parents (Br. 2, n. 1), the Commissioner's proposed correlative adjustment reducing the income of Security Life would be ineffective. These statements, even if they constituted the whole truth, are irrelevant. The Commissioner's

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allocation covers the period January 1, 1955 through September 15, 1959, when it is undisputed that respondents and Security Life were wholly-owned subsidiaries of Holding Company. The fact that a reorganization took place subsequent to the years in issue is of no consequence, since the common control requirement of Section 482 need only exist at the time related taxpayers engage in the transactions in question. *Rooney* v. *United States*, 305 F. 2d 681 (C.A. 9).

Respondents, however, have neglected to disclose that in April, 1970, the corporate parents of respondents and Security Life were re-unified. See Moody's *Bank and Finance Manual* (1971), p. 348. Today, as during the taxable years in issue, therefore, respondents and Security Life are controlled by a single holding company, and respondents could now as easily be made whole through arrangements adopted by the common parent as they could have been in the earlier years.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

JANUARY 1972.

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No. 70-805

In the Supreme Court of the United States

October Term, 1971

Commissioner of Internal Revenue, petitioner

v.

First Security Bank of Utah, et al

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

S. J. QUINNEY
ALONZO W. WATSON, JR.
STEPHEN H. ANDERSON
Counsel for Respondents

400 Deseret Building
Salt Lake City, Utah 84111

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW AND JURISDICTION

The opinions below and the basis for this Court's jurisdiction are as set forth in the petition.

QUESTION PRESENTED

Where national banks, prohibited by national banking laws from receiving insurance income or engaging in the insurance business, made available to their borrowers credit life, accident and health insurance written by an unrelated insurer, which in turn ceded the risks and premiums to a life insurance company related to the banks, did the Court of Appeals correctly hold under the particular facts of this case that it was improper for the Commissioner to attempt to allocate almost one-half of the premium income to the banks under Sections 61 and 482 of the Internal Revenue Code?

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the petition at p. 2, and App. D 53-57.

STATEMENT

This is a consolidated income tax case for the years 1954 through 1959, primarily involving Section 482 of the Internal Revenue Code of 1954.[1] Section 482 empowers the Commissioner of Internal Revenue to allocate income among business enterprises controlled by the same interests "if he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such * * * businesses."

Respondent banks, First Security Bank of Utah, N.A. (Utah Bank) and First Security Bank of Idaho, N.A. (Idaho Bank), are large, respected national banks, almost one hundred years old, controlled, supervised, and regularly examined by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (Pet. App. A 21). They are owned by the First Security Corporation (Holding Company), the oldest bank holding company in existence, the stock of which is publicly held by thousands of stockholders throughout the United States and in various foreign countries (Pet. App. A and B 19, 38).

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[1] All citations to the Internal Revenue Code, or Code, herein refer to the Internal Revenue Code of 1954 unless otherwise indicated.

Almost a quarter of a century ago the banks began to make available to their borrowers credit life, health and accident insurance, which pays off the debt in case the borrower dies or is incapacitated during the term of his loan. (Pet. App. B 39). The premiums charged were at the uniform rate of $1.00 per $100.00 of coverage per year on a decreasing term basis. That was the rate commonly charged in the industry and was accepted by the Insurance Commissioners of the states involved — Utah, Idaho and Texas (Pet. App. B 39).

The insurance was never more than an incidental part of the banks' primary transactions, the lending of money, and the customers were never required or urged to purchase it. Thus, during the years in issue less than half of the banks' installment loan customers and only 13% of their real estate loan customers took insurance (Pet. App. B 39). As a routine part of loan transactions, the bank loan officer (who was not a licensed insurance agent) explained the function and availability of such insurance. If the customer desired insurance, the loan officer gave him application forms for completion. Bank personnel examined the application, made out a certificate and either collected the premium from the customer or added it to his loan. The completed forms and premiums were transmitted at intervals to the management corporation for the banks, the First Security Company (Management Company), which performed certain bookkeeping functions such as making records of the insurance purchased, and then forwarded the premiums and related work to the insurance carrier (Pet. App. A and B 25-26, 39-40).

Explaining and processing the insurance took only one to two minutes of the loan officers' time on each loan, and the total annual cost to each bank for the time and expense of explaining and processing all of such insurance was less than $2,000.00. That expense was found by both courts below to be negligible. (Pet. App. A and B 25, 40, 49—For the five years in issue, the total cost was $8,929.30 for Utah Bank and $9,826.48 for Idaho Bank).[2]

The banks' articles of incorporation limit them to the business of banking (Pet. App. A 21). And, the national banking laws, 12 U.S.C. Sec. 92 prohibit the banks from engaging in the insurance business or receiving commissions from the sale of insurance. (Pet. App. A, B and D 29, 44-45, 55-56). As a result, the banks never received or attempted to receive any commissions at any time from the sale of the insurance in question. (Pet. App. A and B 29, 45).

From 1948 to April 1, 1954, the credit insurance coverage on the banks' borrowers was carried first by Credit Life Insurance Company of Springfield, Ohio, and later by American Bankers Life Assurance Company of Florida, both of which were independent of Holding Company and its subsidiaries. Commissions varying from 40% to 55% of net premiums were paid by those companies to Ed D. Smith & Sons which was an insurance agency wholly owned by Holding Company. (Pet. App. B 40).

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[2] As found by the Court of Appeals, the benefits received by the banks by way of added protection for the repayment of their loans (over $500,000 paid off during the years in suit, Pet. App. B 40) more than justified the negligible time and expense involved in making the insurance available. (Pet. App. B 49).

American National Insurance Company of Galveston, Texas (National), an independent insurance company, wrote a large volume of credit insurance. Foreseeing a change in the credit insurance business, National, late in 1953, approached Holding Company and other financial institutions with a plan whereby it would write credit insurance for the banks' borrowers. The plan called for Holding Company to create a life insurance subsidiary. The subsidiary's business would be to reinsure the risks of the credit insurance policies written by National for the customers of Utah Bank and Idaho Bank. Profits from the business, if any, could be retained in the subsidiary for investment. In its initial years, the subsidiary would utilize National's established and experienced operating services, such as actuarial and accounting, on a fee basis. If the plan proved successful, the new subsidiary could grow into a full-line direct-writing insurance company. (Pet. App. B 41).

Holding Company adopted National's plan and in June, 1954, incorporated First Security Life Insurance Company of Texas (Security Life), under the laws of the State of Texas. Security Life was a bona fide, viable business enterprise. (Pet. App. A and B 24-29, 41-42). The credit insurance written by National for the two banks was reinsured with Security Life under contracts called reinsurance treaties. Thereunder, National received approximately 15% of the premium dollar for its technical services and Security Life received the balance for its assumption of 100% of the risks under the policies. (Pet. App. B 41). Although Security Life's business proved successful, this result was not assured at the outset. In

relation to its capital structure, Security Life reinsured a large amount of risk, and several aspects of its business could have invited high mortality rates. (Pet. App. B 41-42). During the years in issue neither National nor Security Life paid any commissions.

The banks benefited from having available in their offices the forms and means whereby those applying for loans could also secure credit life insurance: it constituted an added attraction to customers, provided for repayment of insured loans in case of death, illness or disability, and improved public relations by eliminating demands for payment upon the families of deceased or incapacitated borrowers. (Pet. App. B 39). As a result of the additional collateral provided by such insurance, the banks had more than one-half million dollars in loans paid off during the years in issue. (Pet. App. B 40).

On September 15, 1959, as the result of a reorganization pursuant to the Bank Holding Company Act of 1956, 12 U.S.C., Sec. 1841 et. seq., the banks became owned by the First Security Corporation, and Security Life became owned by First Security Investment Company, another publicly held corporation. Under the plan of reorganization, the stock of First Security Investment Company was distributed originally to the shareholders of the First Security Corporation, but the stock was actively traded on the open market and by the end of 1959, 7.2% of the First Security Corporation stock had been sold and 8.9% of the Investment Company stock had been sold. As of February, 1967,

a differential of 48.4% existed in the shareholders of the two corporations. (Pet. App. B 42).

Notwithstanding the fact that for several years Security Life and the taxpayer banks had been owned by separate, publicly held corporation, the Commissioner, by notices of deficiency dated December 21, 1962, proposed to allocate to the banks approximately 47% (about $800,000.00) of Security Life's premium income (after payment of National's management fee) for the years 1954 through 1959. An alternative allocation was made to Management Company. (Pet. App. B 42). Thereafter, the banks and Management Company petitioned the United States Tax Court for a redetermination of that proposed deficiency and the consolidated cases were tried before the Hon. William M. Fay. In a brief opinion, Judge Fay upheld the Commissioner's allocation solely upon what he deemed to be the authority of *Local Finance Corporation v. Commissioner,* 48 T.C. 773 aff'd. 407 F.2d 629 (C.A. 7), certiorari denied, 396 U.S. 956. Judge Fay dissented in *Local Finance* after hearing the trial of this case (48 T.C. at 800), making it clear that he agreed with the taxpayer banks' position in this case.

On appeal, the United States Court of Appeals for the Tenth Circuit reversed Judge Fay's decision with respect to the petitioner banks and reversed and remanded the Management Company's case for further consideration.

The Court of Appeals held that under the particular facts of this case the Commissioner was in error in at-

tempting to allocate approximately $800,000.00 to banks which had never received or attempted to receive income from the sale of insurance, including the six-year period of time from 1948 to 1954 when Security Life was not even in existence, and which expended a "negligible" amount of time and expense in having the insurance available for their customers while benefiting from that availability by having more than $500,000 in loans paid off in five and one-half years.

ARGUMENT

The issue presented was correctly decided upon the particular circumstances of this case by the Court of Appeals. Cases under Section 482 of the Code are essentially factual in nature, and no conflict of law or question of statutory interpretation or application is involved in this case. Consequently, there is no basis and no necessity for further review by this Court.

This Court has denied petitions for certiorari in Section 482 cases 14 times,[3] and has never accepted a case

[3] *Likins-Foster Honolulu Corp. v. Commissioner*, 417 F.2d 285 (C.A. 10), certiorari denied, 397 U.S. 987; *Local Finance Corp. v. Commissioner*, 407 F.2d 629 *(A.C. 7)*, certiorari denied, 396 U.S. 956; *Charles Town, Inc. v. Commissioner*, 372 F.2d 415 (C.A. 4), certiorari denied, 389 U.S. 841; *South Texas Rice Warehouse Co. v. Commissioner*, 366 F.2d 890 (C.A. 5), certiorari denied, 386 U.S. 1016; *Oil Base Inc. v. Commissioner*, 362 F.2d 212 (C.A. 9), certiorari denied, 385 U.S. 928; *Pauline W. Ach, et al v. Commissioner*, 358 F.2d 342 (C.A. 6), certiorari denied, 385 U.S. 899; *Tennessee Life Ins. Co. v. Phinney*, 280 F.2d 38, (C.A. 5), certiorari denied, 364 U.S. 914; *Grenada Industries, Inc. v. Commissioner*, 202 F.2d 873 (C.A. 5), certiorari denied, 346 U.S. 819; *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214 (C.A. 2), certiorari denied, 344 U.S. 874; *Advance Machinery Exch. v. Commissioner*, 196 F.2d 1006 (C.A. 2), certiorari denied, 344 U.S. 835; *Duncan v. Commissioner*, 173 F.2d 218 (C.A. 5), certiorari denied, 337 U.S. 957; *Hugh Smith, Inc. v. Commissioner*, 173 F.2d 224 (C.A. 6), certiorari denied, 337 U.S. 918; *National Securities Corp. v. Commissioner*, 137 F.2d 600 (C.A. 3), certiorari denied, 320 U.S. 794; *Asiatic Petroleum Co. v. Commissioner*, 79 F.2d 234 (C.A. 2), certiorari denied, 296 U.S. 645; rehearing denied, 296 U.S. 664.

arising under that statute for review. In each instance the petitions urged the involvement of important legal questions of general applicability in the administration of the statute, and many petitions cited conflicts. And, in each instance, the Commissioner opposed review by this Court, stating repeatedly that Section 482 basically presents only factual questions. In one of those cases, *Tennessee Life Insurance Co. v. Phinney,* 280 F.2d 38 (C.A. 5), certiorari denied, 364 U.S. 914, the Commissioner acknowledged a direct conflict.[4]

1. Section 482 authorizes the Commissioner to allocate income and deductions between commonly controlled business entities if he determines that such allocation is necessary in order to prevent "evasion of taxes or clearly to reflect the income" of any of such entities. This provision, which first appeared in its present form as Section 45 of the Revenue Act of 1928, was designed—

> "* * * to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability." H.Rep. No. 2, 70th Cong., p. 16 (1939-1, Pt.2 Cum.Bull. 395).

The *test* for determining whether an allocation is warranted under Sec. 482 is whether—

> "* * * the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had *the taxpayer* in the conduct of *his* affairs been

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[4] Brief for the Respondent in Opposition (pp. 6, 7-13), *Tennessee Life Insurance Co., supra,* October Term, 1960, No. 482.

> an uncontrolled taxpayer dealing at arm's length with a n o t h e r uncontrolled taxpayer." Regs. Sec. 1.482-1(c), (Pet. App. D 55). (Emphasis added).

That test has been universally adopted. See e.g., *Davis v. United States,* 282 F.2d 623, 626 (C.A. 10); *Commissioner v. Chelsea Products,* 197 F.2d 620, 623 (C.A. 3); *Oil Base, Inc. v. Commissioner,* 362 F.2d 212, 213-214 (C.A. 9). And, the test was specifically adopted and applied by the Court of Appeals in this case when it concluded that the banks' taxable income would not have been any different if they had dealt with unrelated, uncontrolled third parties rather than with Security Life through National. Of course that inquiry under the statute and regulations is essentially factual, and upon review by this Court it would not lead to the creation of a rule of general application or development of heretofore unknown facets of the tax laws.

Both courts below found that the banks ". . . *never* received or *attempted* to receive commissions or reinsurance premiums resulting from their customers' purchase of credit insurance." (Pet. App. A and B 29, 45). Conversely, as pointed out by the Court of Appeals (Pet. App. B 45), the lower court made no finding that if Security Life did not exist (and the banks were dealing strictly with an unrelated insurance company) that the banks would then receive or attempt to receive such income. As shown by the record, for six full years after the banks began making available the service of credit life, health and accident insurance to their customers — *prior* to the formation of Security Life — the banks dealt exclusively with unrelated insurance companies in an un-

controlled situation. Yet during that time the banks had no contact whatsoever with insurance commissions or profits resulting from their customers' purchase of credit insurance. (Pet. App. A and B 29, 45). The reason why this was and continues to be so is that federal banking law prohibits banks such as the taxpayers here from receiving compensation from the sale of insurance (12 U.S.C. Sec. 92, Pet. App. A, B and D 29, 44-45, 55-56). The penalty for violating that statutory prohibition includes loss of the organization's national banking franchise and personal liability against directors of the bank (12 U.S.C. Sec. 93, Pet. App. D 56-57).

There is no evidence or finding below that the banks would jeopardize their very charters and subject their directors to the risk of personal penalties[5] by violating national banking laws for a few dollars of insurance profit.[6] The evidence is to the contrary. (Pet. App. B 49-

[5] This is no closely held corporation situation where director-officer-owners stand to enrich themselves through corporate devices. These banks are publicly owned through Holding Company, and their directors are independent businessmen from many segments of industry.

[6] On pages 14-15 of his brief the Commissioner alludes to the federal banking laws in question but misinterprets their effect here by making an argument which suggests that the banks are placing in issue the supremacy of the federal tax laws. The Commissioner has missed the point. It is what the existence of the banking laws did to affect the entire structure of the transactions in question that is the point here. As the Court of Appeals found, *because* of the national banking laws, the banks remained aloof from any entitlement to insurance related income. (Pet. App. B 49-50). The Commissioner's reference to *James v. United States*, 366 U.S. 213 (Pet. 15) also misses the point. In *James*, the taxpayer in fact received income, although receipt was illegal. Here, the taxpayers not only did *not* receive any income, they consciously structured their affairs in good faith compliance with federal law so as to remain completely removed from and unrelated to it. In *James*, the taxpayer broke the law and took money for himself. Here, the Commissioner seeks to force the banks to break a law which they at all times have respected, in order to sustain a theoretical allocation of income which will never happen in real life.

50). Thus, the Commissioner's position in these cases is a perversion of what Congress intended Section 482 to achieve. The Court of Appeals recognized that he is using a so-called "controlled" situation to attribute to the banks income which both courts below determined that they would never receive in an uncontrolled situation, resulting in the fiction of attributing hundreds of thousands of dollars to banks *which will never receive that money, and a tax where there is no possibility of income.* (Pet. App. B 50).[7]

The decision of the Court of Appeals in this case accords with the weight of authority that the Commissioner cannot force a taxpayer to violate a law which that taxpayer is in good faith attempting to respect, and that good faith efforts by the taxpayer to comply with the law must be recognized and sustained. *Nichols Loan Corp. v. Commissioner,* T.C. Memo. 1962-149 (21 T.C.M. 805), rev'd on other grounds, 321 F.2d 905 (C.A. 7); *First State Bank v. United States,* (D.C.S.D., decided June 25, 1962), unofficially reported at 62-2 U.S.T.C. Par. 9613; *Campbell County State Bank, Inc. v. Commissioner,*

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[7] The Commissioner's comments in footnote 10, p. 14 of the petition are not responsive to the test required under Section 482. The Commissioner refers to Holding Company's power to designate where the insurance income would go. However, the power to place another person in a position to perform profitable functions has never before been considered the touchstone of taxability. *Crowley v. Commissioner,* 34 T.C. 333 (1960); *Alabama-Georgia Syrup Co. v. Commissioner,* 36 T.C. 747 (1961); *rev'd. on other grounds sub. nom, Whitfield v. Commissioner,* 311 F.2d 640 (C.A. 5); *Nat Harrison Associates, Inc. v. Commissioner,* 42 T.C. 601 (1964). Moreover, it is not the power which may be possessed by Holding Company which controls in this case. Under the test proposed by the regulations under Section 482, *supra,* p. 8, the only relevant consideration is whether the income of the *banks* would be any different if Security Life did not exist or, for that matter, if the banks stood entirely alone, unrelated to any other corporation or controlling individual whatsoever.

37 T.C. 430, 438-443 (1961), rev'd on other grounds, 331 F.2d 374 (C.A. 8); *First Security Bank v. United States,* 213 F.Supp. 362 (D.C. Mont. 1963), aff'd 334 F.2d 120 (C.A. 9); *L. E. Shunk Latex Products, Inc. v. Commissioner,* 18 T.C. 940, 959-961 (1952); *Ray Waits Motors v. United States,* 145 F.Supp. 269 (E.D.S.Car. 1956). See also *Jaeger Motor Car Co. v. Commissioner,* T.C. Memo. 1958-223 (17 T.C.M. 1098), aff'd, 284 F.2d 127 (C.A. 7), certiorari denied, 365 U.S. 860, where the Commissioner, contrary to his present position, was arguing that it would be against the law for the corporation to receive the income in question, and the court agreed.

2. The Commissioner briefly asserts a conflict of circuits (Pet. 7-8), *but does not point out in what respect the two circuits disagree on the interpretations of either of the two statutory provisions involved.* He seeks on general terms to establish a conflict by saying such fact was recognized by the Court of Appeals for the Tenth Circuit. But the language from the opinion of that court refutes the Commissioner and shows only that the Tenth Circuit, as well as the Tax Court, recognized that the fact situations in the two cases were similar. Mere similarity of fact situations, however, does not necessarily give rise to a conflict in the interpretation of legal principles of the kind that it is necessary for this Court to resolve. Courts, as juries, will continue to draw different conclusions from similar factual patterns, despite a decision in a particular case by a higher court that it agrees with one rather than the other interpretation of the facts.

The Tenth and Seventh Circuits have not disagreed

concerning the applicable legal test. Both have accepted and applied the same standard, and nothing in either opinion suggests a different legal analysis of the applicable statutes. The Commissioner went to the heart of the matter in his brief in opposition to the petition for certiorari in *Local Finance* when he told this Court that cases such as this do not present "difficult and fundamental issues in federal tax law" since they involve "essentially factual" questions.[8] Consequently, if the Court grants certiorari it would be only to decide which of the appellate courts took the correct view of fact patterns which have similarities, (but which also have dissimilarities).

The Commissioner's bare, unamplified conclusions (Pet. 11-12) that the Tenth Circuit's opinion will "impair" the "effectiveness" of Section 482, and that it goes to the "meaning and scope" of the statute, are unsupported by any explanation of why that is so, or any showing that the Court of Appeals used an erroneous test for applying Section 482, or a test different from that used by the Seventh Circuit. The fact is that the Tenth Circuit recognized and applied the precise test set forth in the Commissioner's regulations (Reg. Secs. 1.482-1(b) and (c)—Pet. App. B 43-44), and made the resulting fact finding that, under such test, the statute would not apply since the banks' income would not have been any different if Security Life did not exist, and no matter with whom the banks might have been dealing. This was so because of the undisputed evidence that the banks were unwilling to

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[8] Brief for the Respondent in Opposition, p. 15, October Term, 1969, No. 561.

violate national banking laws under any circumstances. The Commissioner reveals his erroneous concept of this crucial point where he attempts to clinch his statements just referred to by asserting incorrectly and contrary to the record (Pet. 13) that the banks' income was less than it would have been under different circumstances. In short, the Commissioner is not really proposing review of a legal principle by this Court, he is seeking another opinion on the facts.

The Commissioner also erred in his statement (Pet. 8) that only one factual difference exists between this case and *Local Finance*. Certain critical differences do exist.

First, in *Local*, there was a finding that the commissions in question *would* have been paid to the finance companies but for the existence of a controlled entity. The Seventh Circuit emphasized that difference as a controlling feature which distinguished *Local* from similar cases involving insurance commissions (407 F.2d at 634). The findings in this case are exactly opposite (Pet. App. B 45, 49-50). All the evidence indicates that the banks would not violate national banking laws (with the consequent severe penalties) under any circumstances.

Second, the Seventh Circuit in *Local* distinguished that case from *Campbell County State Bank, Inc. v. Commissioner, supra*, on the additional ground that in *Campbell* there was a specific finding that "the services performed by the Bank in connection with the insurance were minimal." (407 F.2d at 634). In this case, like *Campbell*, there was a specific finding by the courts below that the banks'

expenses (hence, services performed) in connection with the insurance were "negligible" (Pet. App. A and B 25, 40, 49)[9]

Third, the Tax Court, in *Local,* stressed that "there is no showing that" the amount which the related life insurance company was allowed to retain under the Commissioner's allocation "is not adequate compensation for the reinsurance." (48 T.C. at 792). To the contrary, the record in this case establishes that Security Life earned and needed every cent it received due to the size and nature of the risks it assumed and the fact that several aspects of its business could have invited high mortality rates. (Pet. App. B 41-42).

Fourth, the finance company employees in *Local* were licensed insurance agents; whereas, the bank personnel were not insurance agents (which may account for the fact that almost all of the borrowers in *Local* took insurance, while most of the bank customers did not). (48 T.C. at 779; Pet. App. B 39).

Even assuming arguendo, that a conflict exists between *Local Finance* and this case on the Commissioner's

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[9] It is significant that the banks in this case spent far less time and effort in connection with the insurance than did the finance companies in *Local.* Over the five years involved in suit here, Security Life collected $1,916,241 in net premiums—over one-third *more* than was collected in *Local* (48 T.C. at 784), and yet the finance companies in *Local* spent more than three times as much in handling less insurance over a four-year period than the banks here did in handling more insurance over a six-year period. Moreover, in *Local* as many as 95% of the customers of the finance companies purchased credit insurance (48 T.C. at 776), but less than one-half of the banks' installment loan customers and less than 13% of the banks' real estate customers purchased insurance. (Pet. App. B 39).

limited theory, totally undeveloped in his petition, that lending institutions should be taxed whenever their activities amount to the *"sine qua non"* (whatever that may be) of the insurance business (Pet. p.8, n.8), there is still no compelling legal question for this Court to review. Indeed, *the Commissioner does not ask for review on the point.*

(a) Such a question does not lead to anything new or unique in the law for this Court to decide. Any rule announced on the point could not possibly result in a conclusion more definitive than that each case should be judged upon its own facts. For instance, what if the related insurance company had its own personnel at separate desks in each bank, and *they* (not bank personnel) explained and processed the insurance. Where are the *"sine qua non"* services in that situation?[10] What about situations where corporations make medical (such as Blue Cross, Blue Shield) and other insurance services available to their employees. Would that be a *"sine qua non"* activity resulting in insurance income being attributed to the corporation by the Commissioner? And, what of the many varied facts situations already decided by the courts in the cases cited *infra,* p.1[illegible]? One of the writers of this brief,

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[10] In this case, the availability of insurance had its own built-in benefits to the banks unrelated to any income from insurance premiums. George Eccles, President of the banks, testified that credit life, health and accident insurance on borrowers was beneficial to the banks as security for their loans. No truer statement was ever made. During the years in suit such insurance paid off more than $500,000.00 in bank loans on death claims alone, against a processing cost of only $2,000.00 per year per bank. As the Seventh Circuit stated in *Nichols Loan Corp. v. Commissioner, supra,* 321 F.2d at 907: "This Court should be slow to override the business judgment of petitioners that lending their facilities to the credit insurance business was beneficial."

Stephen Anderson, tried one of those cases, *Bank of Kimball v. United States*, 200 F.Supp. 688 (S.D. 1962), for the Government—resulting in the only win for the Government on an insurance related case until *Local*. (See Judge Fay's comment to that effect in his dissent in *Local*, (48 T.C. at 808). The Commissioner's "*sine qua non*" theory was not suggested by the government in that case. And, this Court will note from a review of the facts of the case that such a theory would not have strengthened the government's position or changed the result one iota.

It is important in this context to observe that because of the many different fact patterns involved in these types of cases, the issue here does not have overriding and special significance for the insurance or lending industries. The Commissioner's brief in opposition to certiorari in *Local Finance* underscores that point, and refutes his suggestions to the contrary here. (Pet. 10-11).

(b) The arguments advanced by the Commissioner in opposition to a petition for certiorari in *Tennessee Life Ins. Co. v. Phinney, supra,* where an admitted conflict existed, apply with equal force here. The Commissioner argued in that case that "though the question is important, the nature of the conflict is not such as to require resolution by this Court," principally because the case in conflict was an "isolated decision" and the case before the Court was "in accord with the weight of authority."[11] Likewise, with the sole exception of *Local Finance*, courts have repeatedly rebuffed the Commissioner's efforts to levy a

[11] Brief for the Respondent in Opposition, pp. 8-9, October Term, 1960, No. 482.

tax in situations indistinguishable in principle to the one here, and have refused to recognize the Commissioner's proposition that any efforts which "generate" income must result in the inclusion of the amount thereof in the gross income of the person or entity responsible for that effort. *Teschner v. Commissioner,* 38 T.C. 1003, 1007, 1009; *Basye v. United States,* 295 F.Supp. 1289, 1292-1295 (N.D. Calif.); *Ray Waits Motors, Inc. v. United States, supra; Moke Epstein, Inc. v. Commissioner,* 29 T.C. 1005 (1958); *Gaddy Motor Company, Inc. v. Commissioner,* T.C. Memo. 1958-189 (17 T.C.M. 944); *Jaeger Motor Car Co. v. Commissioner, supra; Campbell County Bank, Inc. v. Commissioner, supra; Bank of Kimball v. United States, supra; Paramount Finance Co. v. United States,* 304 F.2d 460 (Ct. Cl. 1962); *Nichols Loan Corp. v. Commissioner, supra; First Security Bank v. United States, supra; First State Bank v. United States, supra.*

See also, *Seieroe and Gerber,* "Section 482 — Still Growing at the Age of 50," 46 Taxes 893, 900-902 (Dec. 1968.

The so-called "generation" of income argument of the Commissioner was described by the Tax Court as being "* * * completely at variance with every accepted concept of Federal income taxation * * * ." *Teschner v. Commissioner, supra,* 38 T.C. at 1007.

All of those previous decisions, plus many others, have settled the trend of this area of the law, and this, plus the factual nature of the issue, is the complete answer to the Commissioner's statement (Pet. 10-11) that

other cases will arise in this context. *Local*, not this case, was the aberration from the rule (uniformly adverse to the Commissioner) and the Commissioner represented to this Court in that case that the matter did not present any questions sufficiently important for review.

(c) Additionally, the importance of cases of all sorts involving insurance companies diminishes rapidly for years after 1959 since, as pointed out by the Tax Court (Pet. App. A 23), the Life Insurance Company Income Tax Act of 1959 in large part eliminated the tax savings on income to insurance companies. Respondent's arguments, (Pet., notes 4 and 5, pp. 8-9, and p. 10), that preferential treatment of life insurance companies still exists under the law. (Secs. 801-820 of the Code), are incomplete. The only tax advantage enjoyed by life insurance companies since 1959 is a deferral of taxes on that portion of the company's income which goes into certain reserves up to a stated limit. After that limit is reached, the entire income of the insurance company is taxed as any other corporation. And, whenever the money in the favored reserves is paid out, a full corporate tax is paid at that time. Hence, the effect of the 1959 Act is to cause every dollar of net income to insurance companies to be subject to an eventual full corporate tax.[12]

3. The bulk of the Commissioner's petition (pp. 8-15) is devoted to representations of alleged administrative

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[12] The Commissioner's attempt to avoid that fact by arguing, Pet. 8-9, notes 4 and 5, and p. 10, that cases still exist for years subsequent to 1959, is misleading. Proposed allocations by the Commissioner reveal nothing whatsoever as to what total taxes are or may be due from the related insurance company absent the proposed allocation. Allocations relate to *who* may be paying the tax, not *how much*, on a comparative basis, will eventually be paid.

importance of this case, suggesting that: it controls $67 million in taxes in 22 groups of other cases (Pet. 10); it contains issues of national impact upon Government officials and private counsel (Pet. 11); and that it raises important questions of law (Pet. 11-15).

Every one of the fourteen previous petitions for certiorari in Section 482 cases[13] (involving every kind of complicated interpretation and application of that statute) have alleged similar considerations, only to be uniformly opposed by the Commissioner on the ground that questions under the statute are "essentially factual." However, the complete answer to the Commissioner's present assertions and expressions of concern is found in the briefs to this Court in *Local Finance*. In that case, which the Commissioner claims involves the identical issues which are present here (Pet. 7-8), the taxpayer's petition for a writ of certiorari advanced the same arguments as are now urged by the Commissioner: administrative importance; controlling effect upon 1,399 cases pending in lower courts involving the allocation of $232,470,659.00 of income; fundamental and important questions of law, and so forth. In his reply, the Commissioner denied all of those arguments and solemnly declared to this Court that the case and issues involved did not merit review, saying:[14]

> "In any event, measurement of the administrative importance ends, as it begins, not with petitioners'

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[13] Note 3, *supra*.

[14] Brief for the Respondent in Opposition, p. 15, October Term, 1969, No. 561.

assertion (Pet. 22) that this case raises 'some of the most difficult and fundamental issues in federal tax law,' *but rather with recognition that an essentially factual question is presented. Further review by this Court consequently is unwarranted.*" (Emphasis added.)

We adopt that representation by the Commissioner. As we have pointed out throughout this brief, there is simply no way of knowing what different sets of facts will control the pending cases referred to by the respondent. (Pet. 10).[15] And, also as pointed out above, the legal questions are not new. The insurance arrangements here are simply variations on a theme already passed upon numerous times by various courts (see the cases cited *supra*, p. 19), in situations invariably controlled by the facts of the particular case. As Judge Fay of the Tax Court stated in his dissent (48 T.C. at 808):

> "It is particularly noteworthy in this context to consider the past history of respondent's attempts to attack various business-connected insurance arrangements. Respondent has pitched his arguments on Sec. 61, 269, 482, and a general argument that income was properly taxable to a lending institution rather than a controlled reinsurer or the shareholders of the lending institution as partners of an insurance agency. *All these approaches have been repeatedly rejected by this and other courts.*" (Emphasis added).

Lastly, the Commissioner's reliance upon the excerpt from H. Rep. No. 1098, 84th Cong., 1st Sess., p. 7 (Pet.

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[15] This also applies to the Commissioner's assertion, Pet. 10, outside of the record, that he has been settling cases on the basis of *Local*.

9), does not correctly interpret the report in question which in context directly supports the bank's position here.[16] The quoted statement refers to some exceptional abuse situations where a subsidiary was caused to charge excessive premiums, which in turn, were paid by the parent as a way to shift the parent's income to the subsidiary. The quotation in the Commissioner's brief reveals that fact itself where it states: "If the subsidiary charges *excessive premiums* . . . ." (Emphasis added). On page 46 of those comments by the Subcommittee, and page 48 of the report of the Committee, the problem is identified as one where a *lender pays* "excessively large net premiums to avoid taxation to itself." The report goes on to state, in a part not quoted by the Commissioner that:

> "It is pointed out that the difficulty is that the prescription of some sort of standards is necessary. It is suggested that one test would be the fact of a premium charge *higher* than the *going rate* for the *type of insurance purchased.*" (Emphasis added).

It is undisputed in this case that the banks were not charging excessive premiums. They were not charging any premiums at all. And, the premiums which were charged by National were the "going rate," as specifically found by both courts below. (Pet. App. A and B 26, 39). In his proposed findings to the Tax Court, the Commissioner admitted in his own brief that:

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[16] The Commissioner's analysis (Pet. 9-10, n.6) of the Committee's intended meaning with respect to the cited report, does not find any support in the language of the report itself. The "excessive premium" referred to in the report was specifically defined as "a premium charge *higher* than the *going rate* for the type of insurance purchased." (Emphasis added).

"4. From 1948 through 1959, the Banks had available for their borrowers, credit life, health and accident insurance, at the *prevailing* and *competitive* rate of $1.00 per hundred or its equivalent . . . ." (Emphasis added).

Thus, the situation considered by the House of Representatives is altogether different from the present situation. And, far from helping the Commissioner, those excerpts from the legislative history of the Life Insurance Company Tax Act of 1955 disclose Congressional opinion that Section 482 would *not* apply to the facts present here. No *lender* paid premiums in this case and the premiums (which were paid by borrowers) were *not* excessive; they were the going, prevailing and competitive rate.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

S. J. QUINNEY
ALONZO W. WATSON, JR.
STEPHEN H. ANDERSON
Counsel for Respondents

August, 1971.

CERTIFICATE OF SERVICE

I, STEPHEN H. ANDERSON, hereby certify that five copies of the foregoing Brief for the Respondents, First Security Bank of Utah, N.A., et al, were air mailed by me by depositing the same in a United States Post Office, postage prepaid, pursuant to paragraph 2, Rule 33 of the Rules of the Supreme Court of the United States, to ERWIN N. GRISWOLD, Solicitor General, Department of Justice, Washington, D.C. 20530, this ....20.. day of August, 1971.

Stephen H. Anderson

STEPHEN H. ANDERSON

Counsel for Respondents

No. 70-305

In the Supreme Court of the United States

OCTOBER TERM, 1971

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FIRST SECURITY BANK OF UTAH, N.A., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

ERWIN N. GRISWOLD,
Solicitor General,

FRED B. UGAST,
Acting Assistant Attorney General,

MATTHEW J. ZINN,
Assistant to the Solicitor General,

BENNET N. HOLLANDER,
STEPHEN SCHWARZ,
Attorneys,
Department of Justice,
Washington, D. C. 20530.

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 163-176)[1] are not reported. The opinion of the court of appeals (R. 182-192) is reported at 436 F. 2d 1192.

JURISDICTION

The judgments of the court of appeals were entered on January 21, 1971 (R. 193). By order dated

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[1] "R." references are to the separately bound record appendix.

April 12, 1971, Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including June 20, 1971. The petition was filed on June 18, 1971, and certiorari was granted on October 12, 1971 (R. 194). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, pursuant to the authority granted in Section 482 of the Internal Revenue Code, the Commissioner properly allocated to the respondent national banks the commission element of the credit life insurance premiums paid by their borrowers in connection with loans, where respondents offered the life insurance to their borrowers ultimately on behalf of a life insurance company under common ownership and control with respondents.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 61 and 482 of the Internal Revenue Code of 1954, of Section 1.482-1 of the Treasury Regulations on Income Tax (1954 Code), and of Sections 5202 and 5239 of the Revised Statutes are set forth in the Appendix, *infra*, pp. 37-41.

STATEMENT

Respondents, First Security Bank of Utah, N.A., and First Security Bank of Idaho, N.A., are national banks which, during the taxable years in controversy (1955 through 1959), were wholly-owned subsidiaries of First Security Corporation ("Holding Com-

pany"), a publicly-owned bank holding company. Since 1948, in connection with their installment and real estate loan business, respondents have offered to their borrowers credit life, health and accident insurance. This insurance, generally referred to herein as credit life insurance, is single-premium decreasing term insurance on the life of the borrower sufficient in amount at least to discharge his debt if he dies or becomes incapacitated during the term of his loan. (R. 27-29, 163-166.)

From 1948 to April, 1954, the credit life insurance purchased by respondents' customers was written by two independent insurance companies at the prevailing industry rate of $1 per $100 of coverage per year on a decreasing term basis. In keeping with the common industry practice, the premium included a built-in allowance sufficient to provide for the payment of a commission to the lending institution which offered the insurance to its borrowers, and the independent insurers in fact paid commissions ranging from 40 to 55 percent of the net premiums collected to Ed D. Smith & Sons ("Smith"), a wholly-owned subsidiary of Holding Company. Though engaged in the business of selling life and casualty insurance, Smith was in no way involved in the sales of credit life insurance and did not report the commissions as taxable income. Rather, they were reported by First Security Company ("Management Company"), another Holding Company subsidiary which provided management and accounting services to the related group. (R. 19, 70-71, 104-108, 136, 164-167, 170.)

Late in 1953, American National Insurance Company of Galveston, Texas ("American National"), anticipating that tax preferences and potential profits from credit life insurance sales would cause lending institutions to establish their own credit life insurance subsidiaries, approached Holding Company with a new plan designed to salvage some of the profits for the independent carriers. The plan called for Holding Company to create a life insurance subsidiary which would reinsure the risks of the credit life insurance written by American National for respondents' borrowers. Profits from the business would be retained in the subsidiary for investment. It was anticipated that in its initial years the subsidiary would utilize American National's actuarial, accounting and other operational services on a fee basis and, if successful, ultimately grow into a full-line, direct writing insurance company. (R. 30, 167-168.)

Holding Company adopted American National's plan and in June, 1954, formed a wholly-owned life insurance subsidiary, First Security Life Insurance Company of Texas ("Security Life"). The credit insurance was written by American National at the prevailing industry rate of $1 per $100 coverage per year and was reinsured with Security Life under contracts called reinsurance treaties, under which American National received approximately 15 percent of the premium dollar as compensation for its managerial services. Security Life retained the balance for the assumption of all of the risk under the policies. (R. 165, 168-170.)

Security Life's sole source of business income was "reinsurance premiums," and its reinsurance business

was very profitable. Organized in 1954 with capital and paid-in surplus totalling $37,500, Security Life, by the end of that year, was reinsuring $6.5 million of credit life insurance. By the end of 1959, Security Life was reinsuring $41.3 million of such insurance. Its profit for the period 1955-1959 was more than $1 million. (R. 168, 170-171.)

Unlike the unrelated companies which wrote credit life insurance for respondents' borrowers prior to April, 1954, Security Life never paid a commission. As a result, after all expenses (including American National's fee) it was able to retain 52.5 percent of the total premiums. In addition to American National's fee, Security Life's expenses consisted primarily of bank charges, taxes and claim settlement expenses. Forty percent of the net premiums would have been a reasonable sales commission on the business covered by the reinsurance treaties and, had Security Life paid such a commission, it still would have realized an underwriting profit of approximately 12.5 cents on each premium dollar. (R. 108, 126-127, 170-171.)

Respondents had numerous banking offices and maintained a routine procedure for offering credit life insurance to their borrowers. Initially, a loan officer, when interviewing a loan applicant, explained the availability and function of credit life insurance and, if the customer desired the insurance, the loan officer provided the necessary application forms. The borrower then completed the application forms and, upon receipt of the executed application, respondents' personnel issued a certificate of insurance and either

collected the premium from the customer or added it to his loan. Respondents' employees then forwarded the completed forms and premiums to Management Company, which made records of the insurance purchased and forwarded the forms and premiums to American National. Management Company also performed the necessary paper work when claims were filed under the policies. The cost to respondents of processing the credit life insurance purchased by their borrowers for the five years in issue was $8,929 and $9,826, respectively. The cost to Management Company of processing the insurance during the same period was $10,150. (R. 166, 169-170.)

Section 5202 of the Revised Statutes (Appendix, *infra*, pp. 39-40) authorizes national banks located in places having 5,000 or fewer inhabitants to act as insurance agents and receive commissions from soliciting and selling insurance. Section 5239 of the Revised Statutes (Appendix, *infra*, p. 41) provides criminal sanctions for any violation of the federal banking laws. From the time respondents began offering credit life insurance to their customers in 1948, their officers and those of Holding Company have believed that it would be contrary to federal banking law, and thus invite the threat of criminal sanctions, for respondents to receive income resulting from their customers' purchase of such insurance. They did not believe, however, that it would be unlawful to solicit, sell and process the insurance. Accordingly, respondents have never actually received commissions or reinsurance premiums resulting from such purchases; rather, the commissions and rein-

surance premiums have always been paid to corporations under common ownership with respondents—specifically, to Smith from 1948 to April, 1954, and to Security Life thereafter. (R. 166-167, 172.)

Security Life included the entire amount of reinsurance premiums received in its income for 1955-1959. Because the income of life insurance companies is subject to a lower effective tax rate than that of ordinary corporations,[2] this resulted in a smaller total tax liability for Holding Company and its subsidiaries than if a portion of the reinsurance premiums had been included in the income of respondents or Management Company. (R. 168, 170-172; Ex. BR-41.)

Section 482 of the Internal Revenue Code of 1954 (Appendix, *infra*, p. 37) empowers the Commissioner to allocate gross income among "two or more organizations, trades, or businesses * * * owned or controlled directly or indirectly by the same interests * * * if he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations * * *." Acting under this provision, the Commissioner determined that 40 percent of the premium income received and included in gross income by Security Life during the years 1955 through 1959 was allocable to respondents, and determined deficiencies

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[2] Both the Life Insurance Company Tax Act of 1955, c. 83, 70 Stat. 36, applicable to the years 1955-1957, and the Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112, applicable to later years (see Sections 801-820 of the Internal Revenue Code of 1954, as amended), accord preferential tax treatment to life insurance companies. See *United States* v. *Atlas Ins. Co.*, 381 U.S. 233.

accordingly.[a] This allocation was to compensate respondents for selling and processing the credit life insurance and thereby to reflect their income clearly. The Commissioner alternatively asserted deficiencies against Management Company by means of a similar allocation of premium income. Both respondents and Management Company sought redeterminations of the deficiencies in the Tax Court. (R. 172-175.)

That court held that the case was controlled by its reviewed decision favorable to the government (two judges dissenting) in *Local Finance Corp.* v. *Commissioner*, 48 T.C. 773, affirmed, 407 F. 2d 629 (C.A. 7), certiorari denied, 396 U.S. 956, and sustained the Commissioner's determination that 40 percent of the premium income was allocable to respondents. It accordingly did not reach the question of the Commissioner's alternative allocation. (R. 174-176.) Respondents appealed, and the Commissioner took a protective cross appeal for review of the decision favorable to Management Company. The Tenth Circuit reversed the decisions of the Tax Court against respondents, holding (R. 191) that the Commissioner's allocation was "arbitrary and capricious and inconsonant with the basic concepts of federal income taxation," and also reversed the decision of the Tax Court for Management Company. It remanded the case for further consideration of the Commissioner's alternative allocation. (R. 192.)

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[a] Of course, if the Commissioner's determination is sustained, Security Life's income would be reduced by the amount of income allocated to respondents. See Treasury Regulations on Income Tax (1954 Code), Section 1.482-1(d)(2).

SUMMARY OF ARGUMENT

A

Section 482 of the Internal Revenue Code provides that where two or more business organizations are owned or controlled by the same interests, the Commissioner of Internal Revenue may allocate gross income between them if he determines that an allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of the commonly controlled entities. The purpose of this broad delegation of authority by Congress to the Commissioner, as revealed in the legislative history and reiterated in the pertinent Treasury Regulations and court decisions, is to prevent the shifting of profits and resultant distortion of income between commonly controlled businesses by placing them on a tax parity with uncontrolled concerns.

The inquiry to be made in every case arising under Section 482 is whether transactions between commonly controlled parties have taken place on terms comparable to those which would have occurred in arm's length dealings between unrelated parties. If this standard is not satisfied, the Commissioner may, by allocating income or deductions, restore the related parties to what he believes their position would have been if they had dealt at arm's length. It is well-settled that the Commissioner's determination under the arm's length standard must be sustained unless shown to be unreasonable, arbitrary, or capricious.

B

The holding below denies the Commissioner the power to allocate gross income under Section 482 in a situation where it is patent that commonly controlled taxpayers have not dealt with each other at arm's length. Any realistic application of the arm's length standard would permit the Commissioner to make an allocation where one member of a commonly controlled group renders services to another member for less than an arm's length charge. That is precisely what occurred here. Respondents offered and sold credit life insurance to their borrowers on behalf of a commonly controlled life insurance company, but did not charge a fee for their services. Yet, under well known industry practice, it is common for a credit life insurance company to pay generous commissions to a lender which solicits business and performs other selling and processing services. In years prior to the formation of their life insurance affiliate, respondents performed identical selling services for independent insurers, and those companies did pay commissions. It follows that in any arm's length arrangement, respondents would have been compensated for their services, and, accordingly, that the Commissioner was fully justified in allocating commission income to respondents in order to reflect their income clearly.

Despite the foregoing, the court of appeals concluded that respondents could not be taxed on the commissions because they did not receive them or earn them, but only generated the business or income. Emphasizing that respondents never directly received insurance-related income from independent insurers,

the court held that even in uncontrolled dealings, respondents would not have realized taxable income from their sales of credit life insurance. And, the court also held that since respondents were prohibited by federal banking law from receiving commissions, and at all times attempted to comply with federal banking law, it was unreasonable for the Commissioner to allocate commissions to them, and thereby place them in violation of law. All these rulings misconstrue Section 482.

C

Neither the fact that respondents never physically received the commissions, nor the conclusion that they did not "earn" commission income can mask the demonstrable reality that respondents did not deal with their commonly controlled insurance company in an arm's length manner. Obviously, the application of Section 482 is not dependent on the receipt of income, for an allocation of gross income thereunder presupposes that the income was not received, but rather diverted by the taxpayer to a commonly controlled affiliate. The question whether a taxpayer has "earned" or only generated income may be crucial in cases involving general principles of tax law, but it is not necessarily critical for purposes of Section 482. Rather, we submit that the Commissioner has the power to allocate compensation whenever one controlled taxpayer has rendered services to another controlled taxpayer for less than an arm's length charge.

D

It does not follow from respondents' failure physically to receive commissions from independent insurers in earlier years that they realized no taxable income from their uncontrolled dealings. On the contrary, since the pre-April, 1954 commissions were paid to another Holding Company subsidiary, Smith, even though it had nothing to do with the sales of credit life insurance, it is apparent that respondents did not deal with Smith at arm's length. Clearly, if Smith had been an unrelated party, respondents would not have allowed it to receive the commissions. An allocation of such commissions to respondents therefore would have been permissible under the same principles which we urge are applicable to the years here in controversy.

E

The apparent prohibitions of federal banking law do not immunize respondents from an allocation under Section 482. According to their own interpretation of that law, they may lawfully solicit and sell credit life insurance, but may not actually receive commissions arising from their activities or report such commissions as taxable income. Even if their interpretation is correct, and even if they structured their activities to comply with the banking law, the fact remains that they rendered the services for which commissions were paid, and that those services would have been compensated if rendered to an unrelated insurer. This is enough, as a matter of federal tax law, to sustain an allocation of commission income

to respondents, and it is federal tax law, not federal banking law, which controls tax liability.

The Commissioner's allocation does not force respondents to violate the federal banking law. It was they, not the Commissioner, who chose to solicit and sell credit life insurance at a rate set at a sufficiently high level to permit the payment of commissions. If their activities did not violate the banking law, the Commissioner's allocation will not, of itself, constitute a violation on their part. And, surely, the payment of taxes would not be an illegal act.

ARGUMENT

THE COMMISSIONER PROPERLY ALLOCATED TO THE RESPONDENT NATIONAL BANKS, PURSUANT TO SECTION 482, THE COMMISSION ELEMENT OF THE CREDIT LIFE INSURANCE PREMIUMS PAID BY RESPONDENTS' BORROWERS

A. Introduction: The arm's length standard

The facility with which trades or businesses may be organized, as well as the many business and tax advantages to be achieved in using more than one business organization, have frequently encouraged taxpayers to proliferate the number of entities used to conduct what is basically a single economic enterprise. The use of such commonly controlled business organizations makes it possible for owners of multiple trades or businesses to manipulate intercompany transactions so as to reduce tax liability. Even in the absence of tax avoidance motives, common control can foster a considerable amount of arbitrary shifting of income or deductions between related taxpay-

ers. See generally, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, Sec. 15.01, *et seq.* (3d ed., 1971).

To avoid some of these consequences, Congress, since the very earliest days of our income tax history, has provided a variety of legal weapons for limiting the use and abuse of commonly controlled trades or businesses. The statutory provision at issue here, Section 482 of the Internal Revenue Code of 1954, is a continuation of prior law enacted to permit the Commissioner "to deny [to taxpayers] the power to shift income * * * arbitrarily among controlled corporations, and to place such corporations rather on a parity with uncontrolled concerns." *Central Cuba Sugar Co.* v. *Commissioner*, 198 F. 2d 214, 216 (C.A. 2); see also *Eli Lilly and Co.* v. *United States*, 372 F. 2d 990, 1000 (Ct. Cl.). First enacted as Section 45 of the Revenue Act of 1928, c. 852, 45 Stat. 791, 806, the statute was designed "to prevent evasion [of taxes by related taxpayers] (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability." H. Rep. No. 2, 70th Cong., 1st Sess., pp. 16-17; see also S. Rep. No. 960, 70th Cong., 1st Sess., pp. 24-25.

In applying Section 482, it is settled that the touchstone is "that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treasury Regulations on Income Tax (1954 Code), Section 1.482-1(b)(1) (Appendix, *infra*, pp. 38-39); *Oil Base, Inc.* v. *Commissioner*, 362 F. 2d 212, 214

(C.A. 9), certiorari denied, 385 U.S. 928; *Baldwin-Lima-Hamilton Corp.* v. *United States*, 435 F. 2d 182, 185 (C.A. 7). In other words, the arrangements contrived by the controlling taxpayer among its several business entities must be tested by what those arrangements would have been if the businesses were not commonly controlled. If the related parties have not acted as they would have in identical, but uncontrolled, arm's length dealings, the Commissioner is empowered to make an allocation pursuant to Section 482.[4] Moreover, because the Commissioner has been given broad discretion to appraise a particular fact situation in making a Section 482 allocation, the courts have uniformly held that his determination is not to be set aside unless clearly shown to be unreasonable, arbitrary and capricious.[5]

There is no dispute among the parties regarding the existence or applicability of these fundamental

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[4] The arm's length standard has long been embodied in the Treasury Regulations interpreting Section 482 and its predecessors (see Treasury Regulations 86, Article 45-1; Treasury Regulations 111, Section 29.45-1; Treasury Regulations 118, Section 39.45-1) and has been adopted by the courts (see, *e.g.*, *Borge* v. *Commissioner*, 405 F. 2d 673 (C.A. 2), certiorari denied, 395 U.S. 933; *Commissioner* v. *Chelsea Products*, 197 F. 2d 620, 623 (C.A. 3); *Simon J. Murphy Co.* v. *Commissioner*, 231 F. 2d 639, 644 (C.A. 6); *Davis* v. *United States*, 282 F. 2d 623 (C.A. 10); *Eli Lilly and Co.* v. *United States*, 372 F. 2d 990, 1000 (Ct. Cl.)).

[5] *G. U. R. Co.* v. *Commissioner*, 117 F. 2d 187, 189 (C.A. 7); *Ballentine Motor Co.* v. *Commissioner*, 321 F.2d 796, 800 (C.A. 4); *Spicer Theatre, Inc.* v. *Commissioner*, 346 F. 2d 704 (C.A. 6); *Rooney* v. *United States*, 305 F. 2d 681 (C.A. 9); *Grenada Industries, Inc.* v. *Commissioner*, 17 T.C. 231, 255, affirmed, 202 F. 2d 873 (C.A. 5), certiorari denied, 346 U.S. 819.

rules for judging the propriety of a Section 482 allocation.[9] Respondents recognize (Br. in Opp. 10), as they must, that the standard of "an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer" (Treasury Regulations on Income Tax (1954 Code), Section 1.482-1(b)(1)) has been "universally adopted." And the court of appeals, although rejecting the Commissioner's allocation, purported to adhere to the arm's length standard (R. 186-187, 191).

B. The Commissioner's allocation was proper because respondents rendered services for a commonly controlled corporation, without charge, for which they would have been compensated had the parties been dealing at arm's length

The facts leave no room for doubt that during the taxable years in question respondents rendered services for their commonly controlled affiliate, Security Life, without charge, for which they would have been compensated had the parties been dealing at arm's length. Indeed, one need not search far to ascertain the precise amount of the commission income properly allocable to respondents. Common practice in the credit life insurance industry and the fact that independent insurers paid commissions prior to the formation of Security Life graphically demonstrate the correctness of the Commissioner's determination that 40 percent of the "reinsurance premiums" received

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[9] There is likewise no dispute that respondents, Holding Company and all of its affiliates were commonly controlled trades or businesses within the meaning of Section 482 during the taxable years in controversy.

by Security Life (*i.e.*, the commission element) was alloeable to respondents.

1. *In an arm's length transaction an unrelated insurer would have paid commissions*

It is undisputed that during the years in issue, respondents' borrowers paid for credit life insurance at the prevailing industry rate of $1 per $100 coverage each year (R. 170). The evidence also shows (R. 108, 126-127), and the courts have recognized, that the industry-wide premium rate is sufficient to allow insurers to pay sizeable commissions to the lender which solicits the business and sells the insurance. See *Local Finance Corp.* v. *Commissioner*, 48 T.C. 773, 786, affirmed, 407 F. 2d 629, 631-632 (C.A. 7), certiorari denied, 396 U.S. 956; *Alinco Life Insurance Co.* v. *United States*, 373 F.2d 336, 337-338 (Ct. Cl.); *Liston Zander Credit Co.* v. *United States*, 276 F. 2d 417, 423-424, n. 15 (C.A. 5). Finally, as the Seventh Circuit observed in *Local Finance Corp.* v. *Commissioner*, *supra*, 407 F. 2d at 632, "[i]t is well known that insurers pay solicitors a portion of the premium as a commission for generating and processing the insurance." See also R. 105-106. These facts, in and of themselves, are sufficient to demonstrate that if respondents had been dealing with an unrelated insurance company during the years in issue, instead of with their commonly controlled affiliate, Security Life, the unrelated insurer would have paid commissions.

Any argument to the contrary is foreclosed by respondents' own experience prior to the formation of

Security Life in 1954. From 1948 to April, 1954, respondents offered credit life insurance to their borrowers, just as they did during the years in issue, and the independent insurers paid commissions ranging from 40 to 55 percent of the premiums collected. Unlike the independent companies, Security Life paid no commissions. In consequence, it was able to retain, after payment of death claims, more than 59 percent of the net premiums received during the period in question, a percentage far greater than an independent company would have realized on the sale of credit life insurance.[7] Given these facts, there is no basis for any conclusion except that—tested by the arm's length standard—Security Life's income was inflated as a result of the inclusion therein of the commission element of the insurance premiums (as well as the underwriting element), and that an allocation was appropriate to reflect its income clearly.[8]

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[7] For example, American National, the seventh largest stock life insurance company in the United States at the time of the trial of this case, operated on a profit margin of less than five percent (R. 25, 33). As for respondents' contention below that Security Life could not afford to pay commissions because it would become actuarially unsound, it is sufficient to note the Tax Court's observation (R. 174-175) that this disability resulted from Security Life's unusually low initial capitalization. Moreover, Security Life's alleged need to retain its cash is undercut by its 1959 dividend distribution of almost $400,000 to its parent company (R. 50, 171). At all events, Security Life's need for capital cannot displace the implicit requirements of Section 482 that, for tax purposes, it must pay a related corporation arm's length compensation for services rendered.

[8] All of the parties clearly understood that, under the reinsurance arrangement with American National, the amount

2. *In an arm's length transaction respondents would have been compensated for their services*

To what entities related to Security Life is the commission element of the insurance premiums allocable under Section 482? That is the only question remaining once it is seen that commissions would have been paid in an arm's length transaction. In our view, this question is not difficult to answer—the commissions should be included in the income of respondents, since they "performed those minimal [but crucial] services which were the *sine qua non* of the insurance business." *Local Finance Corp.* v. *Commissioner*, *supra*, 407 F. 2d at 633. On the record in this case, there can be no doubt on this score. Respondents advised debtors of the opportunity to obtain insurance; they provided the necessary forms; they issued certificates of insurance; and they collected the premiums for the insurer (R. 169). In short, they did what was necessary to sell the insurance.

Respondents' experience prior to the formation of Security Life again precludes a contrary argument, for the undisputed facts are that they were compen-

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retained by Security Life (85 percent of the total premiums) included a commission. Replying to Holding Company's question (R. 129-130) whether a clause should be inserted in the reinsurance treaties providing for the payment of commissions if Security Life ceased to reinsure the risks, American National wrote (R. 131) that, in such circumstances, "an agency contract will be executed with an agency of your selection whereby American National pays a commission on any accident and health premiums being held by American National." American National further advised (R. 131) that "[f]or very good reasons, this matter cannot be mentioned in a reinsurance treaty * * *."

sated by the independent insurers for the services they rendered. Since they were not compensated when they rendered identical services to Security Life, their income—tested by the arm's length standard—was understated as a result of the exclusion therefrom of the commission element of the insurance premiums, and an allocation was appropriate to reflect their income clearly.

That was the result reached in *Local Finance Corp.* v. *Commissioner*, *supra*, the only other precedent directly in point. There, a majority of the full Tax Court and the Seventh Circuit sustained the Commissioner's power to allocate the commission element of insurance premiums from an insurance company to a related lending institution which had solicited the insurance business, but diverted the commissions to the insurer. Moreover, the allocation of gross income in cases where a lender diverts profits to a so-called "captive life insurance company" was specifically approved by Congress in connection with the enactment of the Life Insurance Company Tax Act of 1955, c. 83, 70 Stat. 36. At that time, both congressional tax-writing committees, recognizing the obvious potential for abuse through the arbitrary shifting of income from a lending institution which solicits insurance business to a related insurance company which enjoys preferential tax treatment, stated their understanding that Section 482 provided the Commissioner with ample regulative authority to deal with problems analogous to the problem presented

here. H. Rep. No. 1098, 84th Cong., 1st Sess., p. 7; S. Rep. No. 1571, 84th Cong., 2d Sess., p. 8.

The fact that respondents did not deal with Security Life as they would have dealt with an independent insurer is, we submit, dispositive of this case. The court below thought otherwise. It concluded that the Commissioner was without power to allocate any part of the commissions or reinsurance premiums to respondents because they did not *receive* them (R. 188, 190-191) or *earn* them (R. 190-191), but only *generated* the business or income (R. 189-191). The court also held that since respondents did not physically receive commissions (other than as a conduit) when they dealt with unrelated insurers, they would not have realized taxable income even in uncontrolled dealings, and, therefore, the Commissioner could not allocate commissions to them when they dealt with Security Life (R. 188, 191). Finally, the court accepted respondents' principal argument (Br. in Opp. 11) that the Commissioner's allocation was unreasonable because federal banking law prohibited them from receiving commission income from credit life insurance sales, and because they structured their activities in such a manner as to comply with that law (R. 187-188; 190-191). We turn now to these aspects of the case.

C. The Commissioner may allocate commission income to respondents even if they neither received nor "earned" such income

In holding that respondents' failure to receive commissions during the years in issue somehow disabled the Commissioner from allocating income to them,

the court below misinterpreted Section 482. Application of that section is not dependent on the receipt of income. See *Asiatic Petroleum Co.* v. *Commissioner*, 79 F. 2d 234, 236 (C.A. 2), certiorari denied, 296 U.S. 645. On the contrary, an allocation of gross income thereunder presupposes that the income was not received by the taxpayer which has so arranged its affairs as to divert the income to another.

Nor is the question whether respondents "earned" the income determinative under Section 482. The court of appeals' conclusion to the contrary (R. 190-191) mistakenly substitutes for the arm's length standard applicable under Section 482 one test for determining to whom income is taxable under Section 61 of the Code (Appendix, *infra*, p. 37). That section provides, to the extent pertinent here, that "gross income means all income from whatever source derived, including * * * [c]ompensation for services, * * * fees, commissions, and similar items * * *." Subsumed thereunder are an amalgam of principles forged by this Court which hold that income is taxed to the true earner thereof (*Lucas.* v. *Earl*, 281 U.S. 111), and that the exercise of power to dispose of income and procure the payment of it to another is the equivalent, for federal tax purposes, of the realization of income (*Helvering* v. *Horst*, 311 U.S. 112). It is true, as both the Tax Court and Seventh Circuit recognized in *Local Finance Corp.* v. *Commisioner*, *supra*, that application of the arm's length standard under Section 482 may on occasion involve the same considerations arising in Section 61

cases.[9] See also *Rubin* v. *Commissioner*, 429 F. 2d 650 (C.A. 2); Bittker and Eustice, *supra*, Sec. 15.06. But it does not follow that the two sections are identical in scope or outlook, for "concepts employed in construing one section of a statute are not necessarily pertinent when construing another with a distinguishable background." [10] *Rohmer* v. *Commissioner*, 153 F. 2d 61, 65 (C.A. 2), certiorari denied, 328 U.S. 862.

If, as the court below implied, Section 482 is merely a specific vehicle for applying Section 61 principles to commonly controlled taxpayers, the provision is superfluous, at least insofar as allocations of gross income are concerned. Our submission is that Section 482 should not be so construed, and that, although it incorporates principles developed under Section 61, it is broader in scope, and permits the Commissioner to reallocate income whenever related parties have not

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[9] For this reason, the Commissioner often predicates tax deficiencies on both Sections 61 and 482 and has done so in this case (R. 163). While under the facts here we believe that respondents "earned" the commissions, at this juncture our reliance is solely on Section 482.

[10] As the Third Circuit has explained (*National Securities Corp.* v. *Commissioner*, 137 F. 2d 600, 602, certiorari denied, 320 U.S. 794):

> In every case in which the section [*i.e.*, Section 482] is applied its application will necessarily result in an apparent conflict with the literal requirements of some other provision of the act. If this were not so Section * * * [482] would be wholly superfluous. We accordingly conclude that the application of Section * * * [482] may not be denied because it appears to run afoul of the literal provisions of * * * [other sections of the Code].

dealt with one another as they would have if they had been unrelated. Compare *Rubin* v. *Commissioner*, *supra*, with *Maxwell Hardware Co.* v. *Commissioner*, 343 F. 2d 713 (C.A. 9); see also Tannenwald, J. concurring in *Local Finance Corp.* v. *Commissioner*, *supra*, 48 T.C. at 799. For example, if employees of Security Life had been stationed in respondents' various branches in order to sell credit life insurance, an allocation may well have been warranted, since, in an arm's length arrangement, an independent insurer would have been required to pay a fee for the use of respondents' premises and the opportunity to conduct its insurance business on those premises. Therefore, the conclusion reached below (R. 190) that respondents did not "earn" commission income, and hence could not be taxed, because their services required minimal effort and negligible cost, cannot conceal the facts that it was they and no one else who rendered the essential services, and that such services would have commanded compensation if rendered to an unrelated party.[11]

Finally, the error in the court of appeals' reasoning is compounded by its assumption (R. 189) that "[t]he position of the Commissioner in effect is that whoever generates income must include the amount thereof in his gross income", and its concomitant rejection of the allocation on the ground that (R. 191) "[g]eneration of business is not enough to impose federal income tax liability." It is unclear precisely what the court meant when it said that respondents

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[11] Similarly, since the Commissioner's allocation was to compensate respondents for selling and processing insurance, the fact that they had no underwriting risk, relied upon by the court of appeals (R. 190), is irrelevant.

only "generated" the income. This is not simply a case involving a diversion of a corporate opportunity or the mere channelling of profitable business from one corporation to another. Respondents performed all of the usual selling and processing services which under credit life insurance industry practice entitle a lender to generous compensation. Thus, to the extent that the decision below is premised on the assumption that respondents only generated the income, it erroneously disposes of the Commissioner's allocation on the basis of a non-existent hypothetical set of facts.

The more fundamental analytical fallacy in the reasoning below lies in the court's apparent view that the Commissioner was imposing a "[g]eneration of income" standard (as opposed, presumably, to a who "earned the income" standard) in determining whether to allocate income under Section 482. In fact, he was imposing neither of these standards. The subtle distinction between earning and generating income has been deemed critical only in the determination of taxability under Section 61. A Section 482 allocation, on the other hand, turns on the entirely different question whether the income of related entities has been distorted because they dealt with each other on a non-arm's length basis.[12]

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[12] For this reason, the court of appeals' comment (R. 189), that generation of income differs from assignment of income (see, *e.g.*, *Crowley* v. *Commissioner*, 34 T.C. 333, 345), is beside the point. Likewise beside the point are cases like *Teschner* v. *Commissioner*, 38 T.C. 1003, which hold, under Section 61, that generation of income does not give rise to taxable income to the generator. Similarly, the court's qualms (R. 190) that acceptance of the "generation of business

D. The failure of respondents physically to receive commissions when dealing with unrelated insurers is no bar to the Commissioner's allocation.

Respondents contend (Br. in Opp. 10-12) and the court below held (R. 188, 191) that since they did not physically receive commissions in arm's length transactions with unrelated insurers prior to April, 1954 —other than as a conduit—they did not realize taxable income from the prior transactions. On the basis of this premise, respondents argue that because they had no commission income in dealings with unrelated insurers, the Commissioner is powerless to allocate commission income to them resulting from their dealings with Security Life.

This argument is incorrect because the premise on which it rests is incorrect. It is true that pre-April, 1954 commissions were paid to Smith, another Holding Company subsidiary. But the fact that they were paid to Smith, rather than to respondents—even though respondents solicited the insurance business and Smith had nothing to do with it—demonstrates that although respondents dealt with the unrelated insurers on an arm's length basis they did not deal similarly with Smith. For this reason, an allocation of commissions from Smith to respondents would have been permissible under Section 482 or its predecessor, if Smith had included the commissions in its income. Smith did not do so, however—the commis-

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theory" will have "alarming consequences on normal commercial practices such as all types of referral business and security commission giveups" are unfounded. Section 482 does not apply to normal commercial transactions between unrelated entities, but only to abnormal transactions between commonly controlled entities.

sions were reported as income by Management Company.[13]

The fact of respondents' non-receipt in the earlier years, then, far from advancing their case, highlights Holding Company's power to designate which of its subsidiaries would receive commissions and which would report them for tax purposes. It also emphasizes the need for a Section 482 allocation to prevent the arbitrary shifting of income among controlled corporate entities. It manifestly does not establish the arm's length standard by which respondents' dealings with Security Life are to be judged.

Moreover, if the arm's length standard is to be determined by reference to receipt and non-receipt in the earlier years, as respondents apparently claim, the bizarre and untenable conclusion is that the Commissioner may allocate the income in question only to Smith, despite the fact that it had no substantive connection with either the earlier or later transactions. Even this argument is not open to respondents, however, for the reporting practices of the Holding Company affiliated group show that it at no time has considered the fact of receipt as the touchstone of taxability.

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[13] The Commissioner's failure in the earlier years to allocate commissions from Management Company to respondents is, of course, no bar to a correct determination for the years here in issue (see *Travis* v. *Commissioner*, 406 F. 2d 987, 990 (C.A. 6); *Massaglia* v. *Commissioner*, 286 F. 2d 258, 262 (C.A. 10); cf. *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180), particularly since the total tax liability of the Holding Company affiliated group would, in those years, have been the same whether or not an allocation was made.

E. The apparent prohibitions of federal banking law on respondents' receipt of income from the sale of insurance do not preclude the Commissioner's allocation

1. *Federal banking law*

Sections 5202 and 5239 of the Revised Statutes provide that a national bank may act as an insurance agent in any place "the population of which does not exceed five thousand inhabitants * * *" and apparently prohibit national banks, under threat of criminal sanctions, from acting as insurance agents in places having a population of more than 5,000. Respondents do not interpret these statutes as prohibiting them from offering life insurance at the industry-wide premium rate (which contains a built-in commission factor), or from performing all of the services necessary to sell such insurance. Rather, respondents read the statutes as barring them only from receiving the commission income and reporting it on their income tax returns.[14] Because of these pro-

[14] There has been some question whether Section 5202 of the Revised Statutes remains in force. Because the provision was omitted from the 1918 amendment and reenactment of Section 5202 of the Revised Statutes by Section 20 of the War Finance Corporation Act, c. 45, 40 Stat. 506, 512, the revisers of the United States Code have omitted it from editions of the Code, subsequent to the 1946 edition, on the theory that it was repealed in 1918. The implicit statutory proscription is, however, incorporated in the Comptroller of the Currency's current Regulations as 12 C.F.R. 2.1-2.5. It is also not entirely settled whether respondents' interpretation of the prohibition is correct. In 1963, the Comptroller of the Currency held (R. 187; Ex. AV) that a national bank in a place with a population exceeding 5,000 could receive income

hibitions on physical receipt, respondents contend (Br. in Opp. 11, n. 6) that they remained aloof from any "entitlement" to insurance-related income, and (Br. in Opp. 12) that the Commissioner, by his allocation, is forcing them to "violate a law" which they have in good faith been attempting to respect.

We accept respondents' representation that their understanding of federal banking law prompted them to structure their affairs so as to remain aloof from the receipt of insurance-related income. Acceptance of their argument that they may not be taxed, however, would accord tax reality to formalistic arrangements which taxpayers devise only to comply with federal or state law requirements based on policy considerations wholly unrelated to Section 482. We submit that even if the arrangements adopted by respondents were required to, and did, satisfy the federal banking law, the question under Section 482 remains whether—applying the standard of arm's length bargaining—respondents' income was clearly reflected during the years when they rendered selling and processing services for Security Life. The answer to this question turns on federal tax law, not on federal banking law, and under the former, illegal gains, like legal gains, are taxable whether received or not. Compare

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from selling credit life insurance if such income was closely related to the bank's normal lending activities. See 12 U.S.C. 24 (Seventh). The Fourth and Fifth Circuits, construing the law in other contexts, subsequently indicated otherwise (see *Commissioner* v. *Morris Trust*, 367 F. 2d 794 (C.A. 4); *Saxon* v. *Georgia Ass'n of Independent Ins. Agents, Inc.*, 399 F. 2d 1010 (C.A. 5)), and the court below apparently followed their decisions (R. 187).

James v. *United States*, 366 U.S. 213, with *Bailey* v. *Commissioner*, 52 T.C. 115, 119, affirmed *per curiam*, 420 F. 2d 777 (C.A. 5), and *Geiger's Estate* v. *Commissioner*, 352 F. 2d 221 (C.A. 8), certiorari denied, 382 U.S. 1012.

2. The Commissioner may allocate commissions to respondents even though they structured their affairs to comply with their interpretation of federal banking law

Respondents concede (Br. in Opp. 11) that federal or state prohibitions on the receipt of income do not preclude the taxation of illegal income if it is received. They argue that since the existence of the federal banking law caused them consistently and in good faith to remain removed from any entitlement to commission income, they would not have received such income even in dealings with unrelated insurers, and, in fact, did not receive commissions prior to April, 1954. We have already shown (pp. 21-22, 26-27, *supra*) that the fact of non-receipt in the earlier, as well as the later, years is no bar to the Commissioner's allocation. Respondents' attempt to use their alleged compliance with the law as a shield against application of the arm's length standard is no different in substance from the argument, rejected long ago by this Court, that a taxpayer may not be taxed on income which he cannot legally claim as his own. See *Lucas* v. *Earl*, *supra*; see also *James* v. *United States*, *supra*.

Even though respondents never physically received commissions, they unquestionably rendered the services for which commissions were paid, and their deal-

ings with Security Life were significantly different from their prior dealings with independent insurers. Clearly, respondents would not (and did not, prior to April, 1954) allow an independent insurer to retain that portion of the premiums representing a built-in allowance for commissions. The only reason that the arrangement with Security Life was countenanced by respondents was because the companies were under common control. To hold the Commisioner powerless to apply Section 482 under these circumstances merely because a commonly controlled group has been able to divert income in supposed compliance with federal or state law would frustrate the purpose of the statute.[15]

3. *The allocation does not force respondents to violate the banking law*

Respondents also maintain (Br. in Opp. 12) that the Commissioner's allocation is unreasonable because it forces them to violate a law which they have been attempting to respect. If respondents have violated the banking law, however, it is their own actions, not the Commissioner's allocation, which would trigger the indictment. The Commissioner has never forced

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[15] Respondents likewise cannot escape the allocation because their dealings with Security Life did not involve tax-avoidance motives. The grant of power to the Commissioner to allocate under Section 482 is in the disjunctive and either a tax-avoidance motive or a failure to reflect clearly the income of the controlled organizations will support an application of the statute. *Asiatic Petroleum Co.* v. *Commissioner, supra; Eli Lilly and Co.* v. *United States, supra; Philipp Brothers Chemicals, Inc.* (N.Y.) v. *Commissioner,* 435 F. 2d 53 (C.A. 2); *Dillard-Waltermire Inc.* v. *Campbell,* 255 F. 2d 433, 436 (C.A. 5).

respondents to engage in selling and processing activities akin to those of an insurance agent, but only to reflect their income clearly. In any event, respondents could have avoided both their federal banking law problems and their federal tax dilemma simply by offering credit life insurance to their borrowers at a lower rate, which did not include the built-in commission factor common in the industry. Security Life still could have realized the standard underwriting profit, and respondents would have fostered their expressed goal (R. 166) of obtaining the benefits of additional collateral which credit insurance provided. Indeed, by charging a lower rate, respondents might well have attracted more loan customers and thereby increased their profits.

Respondents rely heavily (Br. in Opp. 12-13) on a line of authorities presumably standing for the proposition that good faith efforts by the taxpayer to comply with the law must be recognized and sustained. None of these authorities enunciates the broad proposition that good faith efforts to comply with the law preclude the application of Section 482. Many of them are inapposite because they involve the particularized fact question whether a controlling shareholder-officer was selling insurance on behalf of his corporation or in his capacity as a separate insurance agent.[16] Others do not involve Section

[16] *E.g., Moke Epstein, Inc.* v. *Commissioner*, 29 T.C. 1005; *Ray Waits Motors* v. *United States*, 145 F. Supp. 269 (E.D. S.C.); and *Jaeger Motor Car Co.* v. *Commissioner*, 284 F. 2d 127 (C.A. 7), certiorari denied, 365 U.S. 860, each involved holdings that the efforts of an individual officer compelled the

482.[17] Although *Campbell County State Bank, Inc.* v. *Commissioner*, 37 T.C. 430, reversed on other grounds, 311 F. 2d 374 (C.A. 8), refers to a state law prohibiting banks from engaging in the insurance business, the law was regarded as relevant only to show some business purpose (other than the saving of taxes) for the formation of a separate taxable entity to sell insurance. The law was not construed to preclude application of Section 482.

L. E. Shunk Latex Products, Inc. v. *Commissioner*, 18 T.C. 940, does not stand for the proposition that the legal right to receive income is a necessary prerequisite to the application of Section 482. In *Shunk*, the Tax Court held that an allocation was unreasonable because the price charged by the taxpayer to its controlled distributor was fixed by Office of Price Administration limits. The pivotal fact there was that the taxpayer could not have raised its price even to an uncontrolled distributor; the O.P.A. price levels established a *de jure* arm's length price such that even in uncontrolled dealing, the taxpayer would have been forced to forego the economic benefit attributed by the Commissioner. Here, on the other hand, respondents' own interpretation of federal banking law (which we accept *arguendo*) made it possible to per-

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finding that he, rather than his controlled corporation, had earned commission income. Here, it cannot seriously be contended that respondents did not expend the necessary effort to become entitled to the portion of credit life insurance premiums representing commissions.

[17] *E.g., Nichols Loan Corp.* v. *Commissioner*, 21 T.C.M. 805, reversed on other grounds, 321 F. 2d 905 (C.A. 7).

form insurance-selling services and divert their compensation to Security Life, and as their experience in prior years demonstrates, they would not have forfeited the economic benefit of commission income had Security Life been an unrelated insurer.

In sum, none of the foregoing cases, erroneously characterized by the court below (R. 190) as "indistinguishable" from "the standpoint of principle", supports setting aside the Commissioner's Section 482 allocation, either on the ground that federal banking law prohibited respondents from receiving commission income or on any other ground. The Commissioner's determination here was based on the plain and simple fact that respondents and Security Life, by failing to deal at arm's length, were able to shift income properly attributable to respondents. The allocation was therefore appropriate "to prevent evasion of taxes" and "clearly to reflect the income" of both respondents and Security Life. Under these circumstances, neither the prohibitions of federal banking law nor the fact that respondents structured their affairs to circumvent that law can justify abandoning the arm's length standard and upsetting the allocation.

CONCLUSION

For the reasons stated, the judgments of the court of appeals should be reversed.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

FRED B. UGAST,
Acting Assistant Attorney General.

MATTHEW J. ZINN,
Assistant to the Solicitor General.

BENNET N. HOLLANDER,
STEPHEN SCHWARZ,
Attorneys.

NOVEMBER 1971.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.* Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * * *

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

Treasury Regulations on Income Tax (26 C.F.R.):

Sec. 1.482-1. *Allocation of income and deductions among taxpayers.*

(a) *Definitions.* When used in this section * * *

* * * *

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.—*

(1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions,

credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * * *

(c) *Application.*—Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * * *

Revised Statutes:

SEC. 5202 [as amended by Section 1, Act of September 7, 1916, c. 461, 39 Stat. 752]. * * *

* * * *

That in addition to the powers now vested by law in national banking associations organized

under the laws of the United States any such association located and doing business in any place the population of which does not exceed five thousand inhabitants, as shown by the last preceding decennial census, may, under such rules and regulations as may be prescribed by the Comptroller of the Currency, act as the agent for any fire, life, or other insurance company authorized by the authorities of the State in which said bank is located to do business in said State, by soliciting and selling insurance and collecting premiums on policies issued by such company; and may receive for services so rendered such fees or commissions as may be agreed upon between the said association and the insurance company for which it may act as agent; and may also act as the broker or agent for others in making or procuring loans on real estate located within one hundred miles of the place in which said bank may be located, receiving for such services a reasonable fee or commission: *Provided, however*, That no such bank shall in any case guarantee either the principal or interest of any such loans or assume or guarantee the payment of any premium on insurance policies issued through its agency by its principal: *And provided further*, That the bank shall not guarantee the truth of any statement made by an assured in filing his application for insurance.

[12 U.S.C. (1946 ed.) 92.]

SEC. 5239.

If the directors of any national banking association shall knowingly violate, or knowingly permit any of the officers, agents, or servants of the association to violate any of the provisions

of this Title all the rights, privileges, and franchises of the association shall be thereby forfeited. Such violation shall, however, be determined and adjudged by a proper district or Territorial court of the United States in a suit brought for that purpose by the Comptroller of the Currency, in his own name, before the association shall be declared dissolved. And in cases of such violation, every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other person, shall have sustained in consequence of such violation.

[12 U.S.C. 93.]

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No. 70-305

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1971

COMMISSIONER OF INTERNAL REVENUE, PETITIONER
v.
FIRST SECURITY BANK OF UTAH, N.A., ET AL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF ON BEHALF OF BUD KOUTS CHEVROLET COMPANY, WESLEY H. KOUTS AND MARGARET E. KOUTS, HIS WIFE AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

Ernest Getz
800 First National Building
Detroit, Michigan 48226
Attorney for Amicus Curiae

Of Counsel
George B. Martin
of Dickinson, Wright,
McKean & Cudlip

THE DETROIT LEGAL NEWS, DETROIT, MICHIGAN

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CITATIONS

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BRIEF ON BEHALF OF BUD KOUTS CHEVROLET COMPANY, WESLEY H. KOUTS AND MARGARET E. KOUTS, HIS WIFE AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

This brief, with the written consent of the petitioner and the respondents, is filed on behalf of Bud Kouts Chevrolet Company, Wesley H. Kouts and Margaret E. Kouts, his wife. Copies of the November 3, 1971 request for consent to file an amicus curiae brief in support of respondent taxpayers, together with the written consents of respondents and petitioner, are set forth in their entirety in the Appendix hereto.

INTEREST OF AMICUS CURIAE

Bud Kouts Chevrolet Company, a Michigan corporation, ("Dealership") has been a franchised retail Chevrolet dealer in Lansing, Michigan since 1954. During 1965 and 1966 Dealership filed U. S. corporation income tax returns on a calendar year accrual basis.

Wesley H. and Margaret E. Kouts, his wife, ("Individuals") have been the sole shareholders of the Dealership since its incorporation. In 1965 and 1966 they filed joint U. S. individual income tax returns on a calendar year cash basis.

Sharon Agency, Inc., a Michigan corporation, ("Agency") has been an insurance agent licensed by the Michigan Department of Insurance since 1959. Sharon Ehinger, the adult married daughter of the Individuals, has been the sole shareholder of the Agency since its incorporation.

On September 2, 1969 the Dealership and Individuals filed a petition in the United States Court of Claims, *Bud Kouts Chevrolet Company and Wesley H. and Margaret E. Kouts* v. *United States of America*, No. 359-69, seeking to recover taxes arising from, among other items, income allocated by the Internal Revenue Service first from the Agency to the Dealership and then from the Dealership to the Individuals. Proceedings in that case have been suspended by an Order dated October 26, 1971 granting a Joint Motion for Suspension of Proceedings. The joint motion was based upon the opinion of both parties that "a pronouncement by the Supreme Court in *First Security* will bear substantially upon the issues raised" by the Dearlership and the Individuals.

In the request for consent to file this amicus curiae brief, counsel for the Dealership and Individuals stated:

"Inasmuch as questions under Internal Revenue

> Code section 482 are essentially factual, our client wishes to present to the Court facts and law which will acquaint the Court with the factual and legal background of credit life insurance made available to purchasers of automobiles in Michigan. This background is in some respects substantially different than in *First Security Bank of Utah* and may be of assistance in determining the legal standards to be set forth by the Court.''

The factual situation of Amicus Curiae differs from that of Respondent Banks in that no income was allocated to the Dealership from an insurance company. Instead the Internal Revenue Service allocated to the Dealership income reported by the Agency which sold the group credit life insurance policy to the Dealership. Another difference is that the Internal Revenue Service allocated from the Dealership to the Individuals the same amount of income which it had initially allocated from the Agency to the Dealership.

STATEMENT

The facts relating to Amicus Curiae appear in the Appendix at pages 20 to 26.

ARGUMENT

Petitioner's Application of the Section 482 Standard

Petitioner's determination under Section 482 by which Petitioner seeks to tax Respondent Banks (and the Dealership) is arbitrary in several respects. It ignores *actual* arm's length transactions between Respondent Banks (and the Dealership) and uncontrolled parties. It postulates that parties to an arm's length transaction will commit illegal acts. It ignores that the action of the Respondent Banks (and the Dealership) was based on federal (and state) law and not on tax avoidance.

PETITIONER'S APPLICATION OF THE SECTION 482 STANDARD

At page 16 of its Brief, Petitioner asserts that Respondent Banks "rendered services for their commonly controlled affiliate, Security Life, without charge, for which they would have been compensated had the parties been dealing at arm's length."

The fact is that from 1948 to April, 1954 the Respondent Banks "performed identical selling services for independent insurers . . ." (Pet. Br. 10) and during that entire period Respondent Banks received absolutely no commissions or other payments. (Pet. Br. 27)

Similarly, from 1954 to date, the Dealership has dealt at arm's length with a number of financing institutions, including General Motors Acceptance Corporation ("GMAC"), local banks and national financing institutions, all of which bought Dealership's automobile paper and provided credit life insurance. Both prior and subsequent to the organization of Sharon Agency in 1959, and even today, Delership's customers also obtain credit life insurance through GMAC and other institutions which buy automobile paper.

In every instance, the Dealership has received *not one cent* directly or indirectly from Sharon Agency, GMAC, local banks, the national financing institutions or the insurance companies through which they obtained their group credit life insurance policies even though Dealership performed the same minimal functions regardless of the source of the credit life insurance (20-21 *infra*).

The arm's length transaction is the *non-payment* to Dealership from 1954 to date *of any commission or other monies*, whether credit life insurance was obtained through GMAC, local banks or national financing institutions. Ac-

cordingly, no basis exists for allocation of commissions to the Dealership from the Agency.

2. The Commissioner Should Not Presume That Arm's Length Parties Will Undertake Illegal Acts.

Petitioner states (Pet. Br. 10): ". . . , it is common for a credit life insurance company to pay generous commissions to a lender which solicits business and performs other selling and processing services." If Petitioner is correct, why then did not GMAC, the local banks, national financing institutions, or the insurance companies through which they obtained their group credit life insurance policies pay a commission to the Dealership?

The answer, of course, is because none of these parties would make such an illegal payment. And, if they did, the Commissioner would claim that they could not deduct those payments. In *Boyle, Flagg & Seaman, Inc.*, 25 T. C. 43 (1955), acq. 1956-1 C. B. 3, the Court held that an insurance agency which made payments to automotive dealers of 15-20% of the gross premiums on automobile insurance could not deduct such payments. The Court found that it was illegal under Illinois law for an agency to make any payments except to duly licensed persons and that the automobile dealers who solicited the insurance from each new car purchaser were not licensed. The Court held that although such illegal kickbacks were commonplace in Illinois and thought to be necessary in order to obtain the business, they could not be deducted because they frustrated the insurance laws of the State of Illinois.

Similarly, in the case of Bud Kouts Chevrolet Company, the Commissioner is suggesting that in an arm's length transaction the insurance agency would have paid commission illegally to the Dealership even though those illegal

payments would not have been deductible by the insurance agency and receipt thereof would have caused revocation of Dealership's installment seller's license. (23-24 *infra*)

Amicus Curiae respectfully submits that its seventeen-year experience clearly demonstrates that in an arm's length transaction no such payments are made and that arm's length parties in fact do not act as the Commissioner contends.

THE INEQUITABLE RESULTS IMPOSED BY PETITIONER'S POSITION.

Following the allocation of income to the Dealership from the Agency, the Commissioner then attributed a divident to the Individuals. The Internal Revenue Service report on its examination of the Individuals' 1965 and 1966 income tax returns includes this statement for 1966 and a similar statement for 1965:

> "The calendar 1966 profit from the operation of the credit life insurance business was determined to be $6,114.55. This income was reallocated from Sharon Agency, Inc. to Bud Kouts Chevrolet Co. under the authority of Section 482. This amount is also treated as a dividend to Mr. Kouts, the controlling stockholder, as he did not avail himself of the benefits provided by Revenue Procedure 65-17."

This statement reflects the Internal Revenue Service proposal that if the Agency were to pay a $6,114.55 dividend to Dealership, under the provisions of Revenue Procedure 65-17[1] the dividend would not constitue additional income to Dealership and the amount would not be treated as a dividend to the Individuls.

The Individuals were helpless under the Michigan law which prohibited both Dealership and themselves from

[1] 1965-1 Cumulative Bulletin 832

receiving any of Agency's income. Consequently, the Individuals and the Dealership have paid U. S. income taxes greater than the amount of the allocated commissions, none of which can be directly or indirectly received by any of them.

An example of this preposterous procedure is:

SCHEDULE OF ECONOMIC IMPACT RESULTING FROM INTERNAL REVENUE SERVICE'S POSITION

	DEALERSHIP	SHAREHOLDER
Assumed Tax Brackets	48%	%55

(1) Credit life insurance agency earns net $10,000.

(2) Internal Revenue Service allocates the $10,000 income to the dealership.

(3) Internal Revenue Service states that if the $10,000 is not paid to the dealership it will treat the $10,000 as a constructive dividend from the dealership to the dealership's shareholder.

(4) Tax effect:

Dealership pays tax:

$10,000
x 48%
$ 4,800

Individual pays tax:

$10,000 (constructive dividend)
x 55%
$ 5,500

Total tax paid:

$ 4,800
5,500
$10,300

(5) The detriment is greater if the shareholder of the

dealership is in a higher tax bracket.

(6) Neither the dealership nor the individual legally can receive the $10,000; this amount is still in the credit life insurance agency. To follow the procedure to its logical conclusion, the individual has made a gift of $10,000 to the shareholder of the agency as a contribution to the capital of the corporate agency. Depending upon the U. S. gift tax situation of the individual in the year of the Section 482 allocations, additional detriment will occur through reduction of the $30,000 lifetime exemption or the imposition of a gift tax.

The self assessment system of taxation succeeds in the United States of America because, in part, at least, the taxpayer feels that the system generally operates fairly. That feeling of confidence in the fairness of the system is destroyed when the Commissioner's actions impose a substantial economic detriment upon a person, notwithstanding his good faith efforts to be a law abiding citizen, and when he is treated as if he should have been paid illegal kickbacks.

Amicus Curiae respectfully urges the Court to affirm the Tenth Circuit judgment and to reject the unreasonable and unsupported assumptions made by the Commissioner.

Respectfully submitted,

ERNEST GETZ

Dickinson, Wright, McKean & Cudlip
800 First National Building
Detroit, Michigan 48226
Attorney for Amicus Curiae

APPENDIX

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APPENDIX

November 3, 1971

Erwin N. Griswold, Esq.
Solicitor General
United States Department of Justice
Washington, D.C. 20530

Stephen H. Anderson, Esq.
Ray, Quinney & Nebeker
Suite 400 Deseret Building
79 South Main Street
Salt Lake City, Utah 84111

Re: *First Security Bank of Utah, N.A., et al. v. Commissioner of Internal Revenue*, 436 F 2nd 1192 (C.A. 10, 1-21-71); certiorari granted October 12, 1971.

Gentlemen:

On behalf of Bud Kouts Chevrolet Company and Wesley H. and Margaret E. Kouts, request is hereby made for the consent of both parties in the captioned case to file a brief as amicus curiae in support of the respondent taxpayer.

We are counsel for the petitioner taxpayers in *Bud Kouts Chevrolet Company, a Michigan corporation; and Wesley H. and Margaret E. Kouts v. United States of America*, United States Court of Claims 359-69. Our case has been referred to Commissioner Saul Richard Gamer. Kenneth R. Boiarsky is the U. S. Department of Justice attorney assigned to the case.

The parties in *Bud Kouts Chevrolet Company* have filed a joint motion for suspension of proceedings, a copy of which motion is enclosed. This motion was allowed on October 25, 1971 by Commissioner Gamer.

For the reasons stated in the joint motion the amicus curiae has an immediate and direct interest in the U.S. Supreme Court's review of the *First Security Bank of Utah* decision and in an affirmation of the Tenth Circuit's judgment and decision in that case.

The petition for a writ of certiorari to the United States Court of Appeals for the Tenth Circuit filed on behalf of the Commissioner of Internal Revenue in the captioned case states in part at page 10:

> "We are advised by the Internal Revenue Service that, in addition to the instant case, there are presently pending, judicially and administratively, substantially identical cases involving 22 groups of related taxpayers in which the net tax in dispute is estimated to exceed $67 million. The largest of these groups consists of some 1,000 related taxpayers."

The amicus automobile dealer probably is a member of one of these groups.

Inasmuch as questions under Internal Revenue Code section 482 are essentially factual, our client wishes to present to the Court facts and law which will acquaint the Court with a factual and legal background of credit life insurance made available to purchasers of automobiles in Michigan. This background is in some respects substantially different than in *First Security Bank of Utah* and may be of assistance in determining the legal standards to be set forth by the Court.

Favorable consideration of this request for consents to file a brief as amicus curiae is respectfully solicited.

Cordially,
ERNEST GETZ

IN THE UNITED STATES COURT OF CLAIMS

No. 359-69

BUD KOUTS CHEVROLET COMPANY,
a Michigan Corporation, etc.,

Plaintiffs,

v.

THE UNITED STATES OF AMERICA,

Defendant.

JOINT MOTION FOR SUSPENSION OF PROCEEDINGS

Come now the parties, by their attorneys, and respectfully move the Court for a suspension of the proceedings in the above-entitled action for the reasons and period of time stated below. This is the first request made for this purpose.

As reason therefor, the parties state that on June 18, 1971, the Government applied for certiorari to the Supreme Court in *First Security Bank of Utah, N.A.* v. *Commissioner*, 436 F. 2d 1192 (C.A. 10, 1971), based primarily upon the conflict of that decision with the decision in *Local Finance Corp.* v. *Commissioner*, 407 F. 2d 629 (C.A. 7, 1969), cert. denied, 396 U.S. 956 (1969). On October 12, 1971, the petition for certiorari was granted by the Supreme Court, and defendant's trial attorney is advised that the Government's

brief in respect thereto is due on November 26, 1971. The parties are of the opinion that a pronouncement by the Supreme Court in *First Security* will bear substantially upon the issues raised in the instant action, and we accordingly request that the proceedings in this action be suspended until the decision by the Supreme Court is handed down. The parties believe further proceedings in the instant action at this time to be undesirable not only from the standpoint of trial costs which may be unnecessarily incurred but also to be undesirable in advance of a clarification by the Supreme Court of the appropriate areas of factual and legal inquiry which may serve as a guide to the parties in their further trial preparation and afford an opportunity for a more proper and cogent presentation to the Court.

WHEREFORE, the parties request that their motion for suspension of proceedings be allowed.

Respectfully submitted
ERNEST GETZ
Attorney for Plaintiffs
FRED B. UGAST
Acting Assistant Attorney General
KENNETH R. BOIARSKY
Attorneys for Defendant

October 15, 1971

Office of the Solicitor General
Washington, D.C. 20530
November 5, 1971

Ernest Getz, Esq.
800 First National Building
Detroit, Michigan 48226

Re: Commissioner of Internal Revenue v. First Security Bank of Utah, N.A., et al, No. 70-305, October Term, 1971

Dear Mr. Getz,

In response to your letter of November 3, I hereby consent to your filing a brief amicus curiae in the above-entitled case on behalf of Bud Kouts Chevrolet Company and Wesley H. and Margaret E. Kouts.

Very truly yours,
ERWIN N. GRISWOLD,
Solicitor General

RAY, QUINNEY & NEBEKER
Attorneys at Law
Suite 400 Deseret Building
Salt Lake City, Utah 84111

November 10, 1971

Ernest Getz, Esq.
Dickinson, Wright, McKean & Cudlip
800 First National Building
Detroit, Michigan 48226

Re: *First Security Bank of Utah, N.A., et al v. Commissioner of Internal Revenue*, 436 F.2d 1192 (C.A. 10, 1-21-71); certiorari granted October 12, 1971.

Dear Mr. Getz:

Pursuant to the request contained in your letter of November 3, 1971, we hereby consent to your filing a brief as amicus curiae in the above-captioned action on behalf of your client, Bud Kouts Chevrolet Company and Wesley H. and Margaret E. Kouts.

Very truly yours,
STEPHEN H. ANDERSON

STATE OF MICHIGAN

FRANK J. KELLEY, ATTORNEY GENERAL

INSURANCE AGENTS:

Group credit insurance policyholder

MOTOR VEHICLE INSTALLMENT SALES

Licensed insurance agents cannot lawfully reimburse group credit insurance policyholders for any portion of expense

incurred in administration of policies when the group policyholder is an installment seller licensed under the Motor Vehicle Sales Finance Act.

Opinion No. 4572 February 3, 1967

Mr. Charles D. Slay
Commissioner of Banking
Department of Commerce
Lansing, Michigan

You have asked for my opinion as to whether licensed insurance agents can lawfully reimburse group policyholders for any portion of expenses incurred by such policyholders in administration of policies when the group policyholder is an installment seller licensed under Act 27, PA 1950, the Motor Vehicle Sales Finance Act.

Group credit insurance covering a group of borrowers from a single financial institution, or a group of purchasers from a single vendor, is specifically authorized by section 4416 of Act 75, PA 1937, as amended (CLS 1961 § 500.4416; MSA 1965 Cum Supp § 24.14416), which is the Insurance Code.

You advise me that credit insurance has become very widely used in connection with the retail installment sale of motor vehicles, and that the purchaser's basic decision with respect to credit insurance covering the financed portion of the purchase price of an automobile is made at the time the credit is negotiated and issued; usually at the automobile dealer's place of business. You further advise me that a substantial number of corporations, each responsible for the sale of a group credit insurance policy to one automobile dealer, are duly licensed as insurance agents.

Rule 501.52 (II), 1954 Michigan Administrative Code, page 6906, pertaining to insurance, provides:

> "(1) The department of insurance does not condone payment of premiums otherwise than in cash.
>
> "(2) Wherever the insurer proposed to compensate the employer or other policyholder, or anyone else other than the insurer's usual representatives, for record keeping, claim adjustment, or other services, in connection with any contract of group insurance, such agreement or arrangement must first be submitted to the department for approval; and such supporting information as to the bona fide of the arrangement as the department may require shall be supplied before its inception and during its continuance."

To clarify Rule 501.52 (II), supra, the commissioner of insurance has been asked to issue informal "guidelines" governing the practices of these licensed corporate insurance agencies relating principally to premiums charged for such insurance and to the portion of such premiums which may be used for agents' commissions. The suggested "guidelines" are as follows:

> "This Department approves, pursuant to Rule 501.52 (II), reimbursement to the policyholder by the licensed insurance agency of expense actually incurred by the policyholder in the administration of the policy, subject to the following:
>
> "(1) Reimbursement shall be limited to an amount equal to expense actually incurred by the policyholder in paying sales and clerical personnel for offering credit insurance, explaining rates and cover-

age, recording, maintaining and transmitting information relative thereto, and other such administrative and record keeping services and a proper proportion of general office overhead allocable to such activities.

"(2) Such reimbursement shall be made only against invoices (copies of which shall be available for inspection by the Department) submitted by the policyholder to the licensed agency, showing such expense incurred either (a) by categories or (b) as a fixed sum per certificate issued.

"(3) The aggregate of such reimbursement covering any period shall not (without the prior approval of the commissioner) exceed the lesser of (a) the amount of such expense actually incurred during such period or (b) a sum equal to 15% of the gross premiums paid by the policyholder during the period in question."

Whether the implementation of the above provisions would be in violation of section 31(c) of the Motor Vehicle Sales Finance Act (Act 27, PA 1950, as amended, being CLS 1961 § 492.131; MSA 1957 Rev Vol § 23.628(31)(c)) is the question at hand. The pertinent part of section 31(c) provides:

"No insurance company, agent or broker shall pay or cause to be paid, directly or indirectly, to any installment seller, nor shall any installment seller receive from any such insurance company, agent or broker, any portion of any insurance premium involved in the retail installment sale of a motor vehicle other than for the benefit of the installment buyer, and all such payments shall be held by the in-

stallment seller in trust for the benefit of the installment buyer and shall be paid to such installment buyer within 30 days, unless used in procuring comparable insurance or credited to matured unpaid installments under the contract as provided in section 16, subdivision (f) of this act."

Section 16(a) of the Motor Vehicle Sales Finance Act, supra, provides:

> "The buyer of a motor vehicle under an installment sale contract may be required to provide insurance on such motor vehicle at the buyer's expense for the protection of the seller or subsequent holder. *Such insurance shall be limited to insurance against substantial risk of damage, destruction or theft of such motor vehicle*: Provided, however, That the foregoing shall not interfere with the liberty of contract of the buyer and seller to contract for travel emergency benefits pertaining to the operation of the automobile *or other or additional insurance as security for or by reason of the obligation of the buyer,* and inclusion of the cost of such insurance premium and said travel emergency benefits in the principal amount advanced under the installment sale contract ...." (emphasis supplied).

Credit life insurance would come within the category of "insurance as security for or by reason of the obligation of the buyer."

I perceive no conflict between the provision of section 4416 of the Insurance Code, supra, which authorizes issuance of group credit insurance to a group of purchasers from a single vendor subject to certain limitations, and section 31(c) of the Motor Vehicle Sales Finance Act which

specifically prohibits any reimbursement to installment sellers of any portion of any insurance premium involved in the retail installment sale of a motor vehicle other than for the benefit of the installment buyer.

Therefore, section 31(c) is controlling and your question is answered: No, licensed insurance agents cannot lawfully reimburse a group policyholder for expenses incurred by such policyholder when the group policyholder is an installment seller licensed under the Motor Vehicle Sales Finance Act.

FRANK J. KELLEY
Attorney General

FACTS RELATING TO AMICUS CURIAE

Sales of Credit Life Insurance to Automobile Purchasers in Michigan

Sharon Agency, Inc. ("Agency") has been an insurance agent licensed by the Michigan Department of Insurance since its incorporation in Michigan in 1969. During 1965 and 1966 its entire income was derived from the sale to the Dealership of a group credit life insurance policy. This income consisted of commissions on all premiums paid by members of the group; i. e., customers of the Dealership. The Agency is an accrual basis taxpayer whose taxable year ends on June 30.

The sole shareholder of Sharon Agency, Inc. is and has been since its incorporation Sharon Ehinger, the adult, married daughter of the Individuals. The entire capital of the Agency was contributed by Mrs. Ehinger from her own monies. Sharon Ehinger has no interest in any stock in the Dealership. Neither Mr. nor Mrs. Kouts has ever been a director, officer or stockholder of the Agency.

Prior to the creation of the Agency, the Dealership made credit life insurance available to its customers. In 1965 and 1966 (and today) credit life insurance is made available to customers of the Dealership through sources other than Sharon Agency, Inc., such as General Motors Acceptance Corporation ("GMAC").

Customers of the Dealership obtain credit life insurance through GMAC, a local bank or any other institution that bought Dealership's car paper in the following manner. At or about the time of closing the sale of the automobile, the salesman for the Dealership would ask whether the customer desired credit life insurance coverage. If the salesman obtained an affirmative answer, he then instructed the customer where to sign the installment sales contract

form and make a check in the appropriate box for the inclusion of credit life insurance. After the Dealership computed the monthly payment, including the charge for credit life insurance, the contract was forwarded to GMAC or whatever financial institution purchased the paper. That institution subsequently sent the certificate of insurance to the debtor. This procedure has remained essentially unchanged from 1954 to the present time.

In the event a customer obtained credit life insurance through the group policy issued to the Dealership by the Agency the following procedure would obtain. At or about the time of closing the sale of the automobile, the salesman for the Dealership would ask whether the customer desired credit life insurance coverage. If the salesman obtained an affirmative answer, he then instructed the customer where to sign the installment sales contract form and make a check in the appropriate box for the inclusion of credit life insurance. After the Dealership computed the monthly payment, including the charge for credit life insurance, the contract was then forwarded to GMAC or whatever financial institution purchased the paper. The certificate of insurance was prepared by the Dealership and delivered at the time of the closing to the customer. This procedure has remained essentially unchanged from 1959 to the present time.

If the automobile purchase and credit life insurance were financed through an institution other than GMAC the same procedure was followed, although the rates for credit life insurance would differ from those charged by GMAC. Customers can and do obtain credit life insurance through the Agency whether or not the automobile purchase was financed by GMAC.

It was customary in the industry for financing agencies

including GMAC, a local bank or finance company to create a dealer reserve account under which some percentage of the amount being financed (not to exceed 4%) would be paid to the Dealership in the event the debtor completed installment payments. The dealer reserve arrangments with all financing institutions includes the amount of the credit life insurance premium paid by the debtor. Thus, the Dealership was paid an amount (4% in 1965 - 1966) by the financing institutions on the amount financed, including the premium for credit life insurance.

The books and records of the Agency were kept by, its checks were issued by, its paperwork was done by and telephone inquiries were answered by employees of the Agency who were paid by the Agency. These persons also were employees of the Dealership.

At no time did the Dealership or the Individuals receive any compensation of any kind from any insurance agency or the insurance company who wrote the credit life insurance, whether such insurance was obtained through GMAC, a local bank, a national financing institution or the Agency. Nor was the Dealership reimbursed for the expenses, if any, it may have incurred in connection with the issuance of the certificate of insurance, i. e., determining whether the purchaser wished to purchase credit life insurance, the checking of the box on the installment contract, the typing of the aplication form and the determination of the amount owed by the purchaser, including the premium for the credit life insurance policy.

The reason is simple. In the State of Michigan the Department of Insurance has statutory responsibility for licensing insurance agents, and no individual, partnership or corporation may act as an insurance agent without first obtaining a license.

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The Insurance Department for many years has had a published regulation precluding the sale by automobile dealers of public liability and property damage insurance on financed automobiles. Although the regulation did not cover credit life insurance, as early as 1957 the Insurance Department took the flat position that:

> "We do not issue insurance agents licenses to automobile dealers."

The State Banking Department of Michigan, which must license any automobile dealer who wishes to make an installment sale of the motor vehicle, has taken the position that the Michigan Motor Vehicle Sales Finance Act bars automobile dealers from selling any insurance for profit on automobiles sold on installment basis. Section 16 and 31 of that act imposed restrictions and regulations on the sale of insurance in connection with an installment sale on a motor vehicle and in particular Section 31 (c) provides in part:

> "No insurance company, agent or broker shall pay or cause to be paid, directly or indirectly, to any installment seller, nor shall any installment seller receive from any such insurance company, agent or broker, any portion of any insurance premium involved in the retail installment sale of a motor vehicle . . ."

Ultimately, the Michigan Department of Insurance approved the creation of corporate insurance agencies whose stockholders, officers and directors consisted of the relatives and business associates of the stockholders of the franchised automobile dealership. Stockholders of a dealership were prohibited from participating directly or indirectly in this type of insurance agency. Any dealership which ignored this prohibition was subject to revocation of

the license which permitted it to sell automobiles on an installment basis.

Each of the corporate agencies included among its officers a licensed insurance agent. These agencies were then issued insurance licenses by the Michigan Department of Insurance which authorized them to sell group policies of credit life insurance and accident and health insurance. Hundreds of these corporate insurance agencies have been formed in Michigan.

Typically, each corporate insurance agency was responsible for the issuance to a dealership of one group policy of credit life insurance insuring the lives of installment purchasers of motor vehicles from that dealership. The licensed insurance agent who became an officer of the corporate insurance agency also was a resident agent for an insurer authorized to do business in Michigan. This agent arranged for the issuance to the dealership of the group policy and received an overriding commission on all premiums processed with respect to the individual certificate holders.

Thus, the industry pattern in Michigan was that the franchised automobile dealership held a group policy of credit life insurance covering a group consisting of its installment purchasers who elected to obtain coverage. The group policy was placed and serviced by an insurance agency which received a commission on all premiums paid by members of the group.

On February 3, 1967, in response to a question by the Commissioner of Banking of the State of Michigan, the Attorney General of Michigan issued an opinion which specifically stated:

> "No, licensed insurance agents cannot lawfully reimburse a group policyholder for expenses incurred by such policyholder when the group policy-

holder is an installment seller licensed under the Motor Vehicles Sales Finance Act."

A copy of such Opinion is set forth in this Appendix.

2. THE ALLOCATION PROCESS

a. To The Dealership

The Internal Revenue Service determined that "for the period beginning 7/1/65 the income from the sale of credit life insurance was actually earned by Bud Kouts Chevrolet Company and that therefore this income and the related expenditures should have been reported by Bud Kouts Chevrolet Company."[1]

The Internal Revenue Service then determined "that Sharon Agency, Inc. did perform certain administrative services for Bud Kouts Chevrolet in earning this income" and was entitled to a fee therefor.

For the last six months of 1965, one-half ($8,464.44) of the income reported by the Agency for 1965 was allocated to the Dealership. However only a portion ($2,918.02) of one-half ($4,057.14) of the expenses reported by the Agency for 1965 was so allocated. The remaining expenses ($1,139.-12) "were determined to be proper expenses of Sharon Agency, Inc."

The Commissioner then disallowed as expenses *to the Dealership* approximately one-half ($1,448.92) of the $2,-918.02 of expenses previously determined as properly allocated to the Dealership.

For calendar 1966, all of the income reported by the Agency ($13,874.68) was allocated to the Dealership but again only a portion ($4,692.46) of the total expenses reported by the Agency ($7,481.24) was so allocated. The

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[1] No action was taken with respect to the first six months of 1965.

remaining portion ($2,788.78) plus 10% was allocated back to the Agency as income and allowed as an expense to the Dealership.

Of the $4,692.46 of expenses allocated to the Dealership, $2,968.56 was then disallowed.

b. To The Individuals

Following the allocation for 1965 to the Dealership of $5,546.42 of net income from the Agency and the allowance of $1,253.03 of administrative expense from the Agency, 100% of the difference ($4,293.39) was, according to the Internal Revenue Service examination report of Mr. and Mrs. Kouts, "treated as a dividend to Mr. Kouts, the controlling stockholder, as the related entities did not avail themselves of the benefits provided by Revenue Procedure 65-17".

Similarly, for 1966 the total net profit from the Agency ($6,114.56) was, again in the words of the examination report, "treated as a dividend to Mr. Kouts, the controlling stockholder, as he did not avail himself of the benefits provided by Revenue Procedure 65-17."

COMMISSIONER OF INTERNAL REVENUE *v.* FIRST SECURITY BANK OF UTAH, N. A., ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

No. 70-305. Argued January 10, 1972—Decided March 21, 1972

Respondent banks were subsidiaries of a holding company that also controlled a management company, an insurance agency, and, from 1954, an insurance company (Security Life). In 1948 the banks began to offer to arrange credit life insurance for their borrowers, placing the insurance with an independent insurance carrier. National banking laws were deemed to prohibit the banks from receiving sales commissions, which were paid by the carrier to the insurance agency subsidiary. The commissions were reported as taxable income for the 1948–1954 period by the management company. After 1954, when Security Life was organized, the credit life insurance on the banks' customers was placed with an independent carrier which reinsured the risks with Security Life, the latter retaining 85% of the premiums. No sales commissions were paid. Security Life reported all the reinsurance premiums on its income tax returns for the period 1955 to 1959, at the preferential tax rate for insurance companies. Petitioner, pursuant to 26 U. S. C. § 482, granting him power to allocate gross income among controlled corporations in order to reflect the actual incomes of the corporations, determined that 40% of Security Life's premium income was allocable to the banks as commission income earned for originating and processing the credit life insurance. The Tax Court affirmed petitioner's action, but the Court of Appeals reversed. *Held:* Since the banks did not receive and were prohibited by law from receiving sales commissions, no part of the reinsurance premium income could be attributed to them, and petitioner's exercise of the § 482 authority was not warranted. Pp. 403–407.

436 F. 2d 1192, affirmed.

Powell, J., delivered the opinion of the Court, in which Burger, C. J., and Douglas, Brennan, Stewart, and Rehnquist, JJ., joined. Marshall, J., filed a dissenting opinion, *post*, p. 407. Blackmun, J., filed a dissenting opinion, in which White, J., joined, *post*, p. 418.

Ernest J. Brown argued the cause for petitioner. On the brief were *Solicitor General Griswold, Acting Assistant Attorney General Ugast, Matthew J. Zinn* and *Bennet N. Hollander.*

Stephen H. Anderson argued the cause for respondents. With him on the brief was *S. J. Quinney.*

Ernest Getz filed a brief for Bud Kouts Chevrolet Co. et al. as *amici curiae* urging affirmance.

MR. JUSTICE POWELL delivered the opinion of the Court.

This case presents for review a determination by the Commissioner of Internal Revenue (Commissioner), pursuant to § 482 of the Internal Revenue Act,[1] that the income of taxpayers within a controlled group should be reallocated to reflect the true taxable income of each. Deficiencies were assessed against respondents. The Tax Court affirmed the Commissioner's action, and respondents appealed to the Court of Appeals for the Tenth Circuit. That court reversed the decision of the Tax Court, 436 F. 2d 1192 (1971), and we granted the Commissioner's petition for certiorari to resolve a conflict between the decision below and that in *Local Finance Corp.* v. *Commissioner,* 407 F. 2d 629 (CA7), cert. denied, 396 U. S. 956 (1969). We now affirm the decision of the Court of Appeals.

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[1] 26 U. S. C. § 482 provides:

"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

Respondents, First Security Bank of Utah, N. A., and First Security Bank of Idaho, N. A. (the Banks), are national banks which, during the tax years, were wholly owned subsidiaries of First Security Corp. (Holding Company). Other non-bank subsidiaries of the Holding Company, relevant to this case, were First Security Co. (Management Company), Ed. D. Smith & Sons, an insurance agency (Smith), and—from June 1954—First Security Life Insurance Company of Texas (Security Life). Beginning in 1948, the Banks offered to arrange for borrowers credit life, health, and accident insurance (credit life insurance). The Tax Court found that they did this "for several reasons," including (1) offering a service increasingly supplied by competing financial institutions, (2) obtaining the benefit of the additional collateral that credit insurance provides by repaying loans upon the death, injury, or illness of the borrower, and (3) providing an "additional source of income—part of the premiums from the insurance—to Holding Company or its subsidiaries."

Until 1954, any borrower who elected to purchase this insurance was referred by the Banks to two independent insurance companies. The premium rate charged was $1 per $100 of coverage per year, the rate commonly charged in the industry. The Insurance Commissioners of the States involved—Utah, Idaho, and Texas—accepted this rate. The Banks followed a routine procedure in making this insurance available to customers. The lending officer would explain the function and availability of credit insurance. If the customer desired the coverage, the necessary form was completed, a certificate of insurance was delivered, and the premium was collected or added to the customer's loan. The Banks then forwarded the completed forms and premiums to Management Company which maintained records of the

insurance purchased and forwarded the premiums to the insurance carrier. Management Company also processed claims filed under the policies. The cost to each of the Banks for the actual time devoted to explaining and processing the insurance was less than $2,000 per year, characterized by the courts below as "negligible." The cost to Management Company of the services rendered by it was also negligible, slightly in excess of $2,000 per year.

It was the custom in the insurance business (although not invariably followed), regardless of the cost of incidental paperwork, to pay a "sales commission"—ranging from 40% to 55% of net premiums collected—to a party who originated or generated the business. But the Banks had been advised by counsel that they could not lawfully conduct the business of an insurance agency or receive income resulting from their customers' purchase of credit life insurance. Neither the Banks nor any of their officers were licensed to sell insurance, and there is no question here of unlawfully acting as unlicensed agents. The Banks received no commissions or other income on or with respect to the credit insurance generated by them. During the period from 1948 to 1954 commissions were paid by the independent companies writing the insurance directly, to Smith, one of the wholly owned subsidiaries of Holding Company. These commissions were reported as taxable income not by Smith but by Management Company which had rendered the services above described. During this period (1948–1954), the Commissioner did not attempt to allocate the commissions to the Banks.[2]

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[2] The corporate income tax imposes the same rate of taxation on taxable income up to $25,000 and the same rate for income greater than $25,000. 26 U. S. C. § 11. Therefore, if, excluding the sales commissions in question, we assume, as seems likely, that before

In 1954, Holding Company organized Security Life, a new wholly owned subsidiary licensed to engage in the insurance business. A new procedure was then adopted with respect to placing credit life insurance. It was referred by the Banks to, and written by an independent company, American National Insurance Company of Galveston, Texas (American National), at the same rate to the customer. American National then reinsured the policies with Security Life pursuant to a "treaty of reinsurance." For assuming the risk under the policies sold to the Banks' customers, Security Life retained 85% of the premiums. American National, which furnished actuarial and accounting services, received the remaining 15%. No sales commissions were paid. Under this new plan,[3] the Banks continued to offer credit life insurance to their borrowers in the same manner as before.[4]

Security Life was not a paper corporation. It commenced business in 1954 with an initial capital of $25,000

1954 the income of both respondents and of Management Company exceeded $25,000, then the total taxes paid by the Holding Company subsidiaries would not be affected if the commissions were allocated wholly to respondents or to Management Company, or partially to all three.

[3] This plan was proposed to Holding Company by American National, which was making similar recommendations to other financial institutions. The Tax Court found that insurance companies anticipated that lending institutions would soon begin to form their own affiliated life insurance companies to write the credit insurance which was proving to be a profitable business. Such a move by lending institutions would deprive the independent insurance companies of substantial credit insurance business. The type of plan recommended by American National was intended to salvage a portion of such business by charging a fee for the actuarial, accounting, and other services made available to Security Life, which reinsured the entire risk. T. C. Memo 1967-256.

[4] Taxpayers are, of course, generally free to structure their business affairs as they consider to be in their best interests, including lawful structuring (which may include holding companies) to minimize taxes. Perhaps the classic statement of this principle is Judge

which was increased in 1956 to $100,000. Although it did not become a full-line insurance company (contemplated as a possibility when organized), its reinsurance business was substantial. The risks assumed by it had grown to $41,350,000 by the end of 1959, and it had paid substantial claims.[5]

Security Life reported the entire amount of reinsurance premiums, 85% of the premiums charged, in its income for the years 1955–1959. Because the income of life insurance companies then was subject to a lower effective tax rate than that of ordinary corporations, the total tax liability for Holding Company and its subsidiaries was less than it would have been had Security Life paid a part of the premium to the Banks or Management Company as sales commissions.[6] Pursuant to his § 482

Learned Hand's comment in his dissenting opinion in *Commissioner* v. *Newman*, 159 F. 2d 848, 850–851 (CA2 1947):

"Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."

See *Knetsch* v. *United States*, 364 U. S. 361, 365 (1960); Chirelstein, Learned Hand's Contribution to the Law of Tax Avoidance, 77 Yale L. J. 440 (1968).

[5] The opinion of the Tax Court, *supra*, includes tables showing the profitability of Security Life. Its net worth (capital and surplus) increased from $161,370.52 at the end of 1955 to $1,050,220 at the end of 1959, despite the paying out of claims and claims expenses over the five-year period totaling $525,787.91. The Tax Court found that: "Although Security Life's business proved to be successful, there was no way to judge at the outset whether it would succeed. In relation to its capital structure, Security Life reinsured a large amount of risk."

[6] Both the Life Insurance Company Tax Act for 1955, 70 Stat. 36, applicable to the years 1955–1957, and the Life Insurance Company Income Tax Act of 1959, 73 Stat. 112, applicable to later years, accorded preferential tax treatment to life insurance companies.

power to allocate gross income among controlled corporations in order to reflect the actual incomes of the corporations, the Commissioner determined that 40% of Security Life's premium income was allocable to the Banks as compensation for originating and processing the credit life insurance.[7] It is the Commissioner's view that the 40% of the premium income so allocated is the equivalent of commissions that the Banks earned and must be included in their "true taxable income."[8]

The parties agree that § 482 is designed to prevent "artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises."[9] Treasury Regulations provide:

> "The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."[10]

The question we must answer is whether there was a shifting or distorting of the Banks' true net income

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[7] The Commissioner made an alternative allocation to Management Company. Because it upheld his allocation to the Banks, the Tax Court rejected this alternative. In reversing the allocation to the Banks, the Court of Appeals found the record insufficient to pass on the alternative allocation. It therefore ordered that the case be remanded to the Tax Court for further consideration. The alternative allocation is therefore not before us.

[8] See 26 CFR § 1.482-1 (a)(6) (1971).

[9] B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders p. 15-21 (3d ed. 1971).

[10] 26 CFR § 1.482-1 (b)(1) (1971). The first regulations interpreting this section of the statute were issued in 1934. They have remained virtually unchanged. Jenks, Treasury Regulations Under Section 482, 23 Tax Lawyer 279 (1970).

resulting from the receipt and retention by Security Life of the premiums above described.[11]

We note at the outset that the Banks could never have received a share of these premiums. National banks are authorized to act as insurance agents when located in places having a population not exceeding 5,000 inhabitants, 12 U. S. C. A. § 92.[12] Although § 92 does not explicitly prohibit banks in places with a population of over 5,000 from acting as insurance agents, courts have held that it does so by implication.[13] The Comptroller

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[11] The court below held that the mere generation of business does not necessarily result in taxable income. As we decide this case on a different ground, we need not consider the circumstances in which the origination or referral of business may or may not result in taxable income to the originating party. We do agree that origination of business does not necessarily result in such income. In this case if the Banks had been unaffiliated with any other entities (*i. e.*, had been separate, independent banks, unaffiliated with any holding company group), they would nevertheless have performed the "services" that the Commissioner asserts resulted in taxable income. These services—namely the negligible paper work and the referring of the credit insurance to a company licensed to write it—were performed (as the Tax Court noted) for the convenience of bank customers and to assure additional collateral for loans. They also may have been necessary to meet competition. The fact of affiliation, enabling referral of the business to another subsidiary in the holding company group, does not alter the character of what was done. The act which is relevant, in terms of generating insurance premiums and commissions, is the *referral* of the business. Whether this referral is to an affiliated or an unaffiliated insurance company should make no difference as to whether the bank, which never receives the income, has earned it.

[12] Section 92 of the National Bank Act was enacted in 1916. When the statutes were revised in 1918 and re-enacted, § 92 was omitted. The revisers of the United States Code have omitted it from recent editions of the Code. However, the Comptroller of the Currency considers § 92 to be effective and he still incorporates the provision in his Regulations, 12 CFR §§ 2.1–2.5 (1971).

[13] *Saxon* v. *Georgia Association of Independent Insurance Agents, Inc.*, 399 F. 2d 1010 (CA5 1968). See *Commissioner* v. *Morris Trust*, 367 F. 2d 794, 795 (CA4 1966).

of the Currency has acquiesced in this holding,[14] and the Court of Appeals for the Tenth Circuit expressed its agreement in the opinion below.

The penalties for violation of the banking laws include possible forfeiture of a bank's franchise and personal liability of directors. The Tax Court found that the Banks, upon advice of counsel, "held the belief that it would be contrary to Federal banking law . . . to receive income resulting from their customers' purchase of credit insurance" and, pursuant to this belief, "the two Banks have never received or attempted to receive commissions or reinsurance premiums resulting from their customers' purchase of credit insurance."[15]

Petitioner does not contest this finding by the Tax Court or the holding in this respect of the Court of Appeals below. Accordingly, we assume for purposes of this decision that the Banks were prohibited from receiving insurance-related income, although this prohibition did not apply to non-bank subsidiaries of Holding Company.[16]

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[14] 12 CFR §§ 2.1–2.5 (1971).

[15] Findings of fact and opinion in T. C. Memo 1967–256, p. 67–1458, filed Dec. 27, 1967, in this case.

[16] Mr. Justice Marshall's dissenting opinion is based on the "crucial fact . . . [that] respondents [the Banks] have already violated the federal statute and regulations by soliciting insurance premiums." The statute, 12 U. S. C. A. § 92, prohibits a national bank from acting "as the agent" of an insurance company "by soliciting and selling insurance and collecting premiums on policies." Mr. Justice Marshall concludes that the banks have violated this statute, and notes that "the penalties . . . are indeed severe."

This finding of illegality, with respect to conduct of the Banks extending back to 1948, is without support either in the record or in any authority cited. Indeed, the record is to the contrary. The Tax Court found as a fact that there was no "agency agreement" between the Banks and the insurance companies; it further found that the Banks *"made available"* the credit insurance to their customers. There is no finding, and nothing in the record to support

We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving. In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, a taxpayer must have complete dominion over it. "The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not." *Corliss* v. *Bowers*, 281 U. S. 376, 378 (1930).

It is, of course, well established that income assigned before it is received is nonetheless taxable to the assignor. But the assignment-of-income doctrine assumes

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a finding, that the Banks were agents of the insurance companies or that they engaged in "selling insurance" within the meaning of the statute. The Banks no doubt "solicited" in the sense that they encouraged their customers to take out the insurance. But in the absence of an agency relationship, and in view of the undisputed fact that the Banks received no commissions or premiums, it cannot be said that there was a violation of the statute. Moreover, the Banks were regularly examined by the federal banking authorities "looking for violations in the national banking laws." The making of credit insurance available to customers was and is a common practice in the banking business. There is no suggestion that the federal banking authorities considered this service to customers to be a violation of the law as long as the Banks received no commissions or fees. This administrative interpretation over many years is entitled to great weight.

The dissenting opinion raises this serious issue for the first time. It was not raised at any stage in the proceedings below. Nor was it briefed or argued in this Court. The Commissioner, the Tax Court, the Court of Appeals, and the Solicitor General all assumed that the Banks' conduct in this respect was perfectly lawful. But quite apart from the consistent administrative acceptance and from the assumptions by the Commissioner and the courts below, we think there is no basis for a finding of this serious statutory violation.

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that the income would have been received by the taxpayer had he not arranged for it to be paid to another. In *Harrison* v. *Schaffner*, 312 U. S. 579, 582 (1941), we said:

> "[O]ne vested with the right to receive income [does] not escape the tax by any kind of anticipatory arrangement, however skillfully devised, by which he procures payment of it to another, since, by the exercise of his power to command the income, he enjoys the benefit of the income on which the tax is laid." [17]

One of the Commissioner's regulations for the implementation of § 482 expressly recognizes the concept that income implies dominion or control of the taxpayer. It provides as follows:

> "The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers." [18]

This regulation is consistent with the control concept heretofore approved by this Court, although in a different context. The regulation, as applied to the facts in this case, contemplates that Holding Company—the controlling interest—must have "complete power" to shift income among its subsidiaries. It is only where this power exists, and has been exercised in such a way that the "true taxable income" of a subsidiary has been

[17] See *Helvering* v. *Horst*, 311 U. S. 112 (1940) (assignment of interest coupons attached to bonds owned by taxpayer); *Lucas* v. *Earl*, 281 U. S. 111 (1930) (taxpayer assigned to wife one-half interest in his earnings). See generally *Commissioner* v. *Sunnen*, 333 U. S. 591 (1948), and cases discussed therein at 604–610.

[18] 26 CFR § 1.482-1 (b)(1) (1971).

understated, that the Commissioner is authorized to reallocate under § 482. But Holding Company had no such power unless it acted in violation of federal banking laws. The "complete power" referred to in the regulations hardly includes the power to force a subsidiary to violate the law.

Apart from the inequity of attributing to the Banks taxable income that they have not received and may not lawfully receive, neither the statute nor our prior decisions require such a result. We are not faced with a situation such as existed in those cases, urged by Commissioner, in which we held the proceeds of criminal activities to be taxable.[19] Those cases concerned situations in which the taxpayer had actually received funds. Moreover, the illegality involved was the act that gave rise to the income. Here the originating and referring of the insurance, a practice widely followed, is acknowledged to be legal. Only the receipt of insurance commissions or premiums thereon by national banks is not. Had the Banks ignored the banking laws, thereby risking the loss of their charters and subjecting their officers to personal liability,[20] the illegal-income cases would be relevant. But the Banks from the inception of their use of credit life insurance in 1948 were careful never to place themselves in that position. We think that fairness requires the tax to fall on the party that actually receives the premiums rather than on the party that cannot.[21]

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[19] *James* v. *United States*, 366 U. S. 213 (1961); *Rutkin* v. *United States*, 343 U. S. 130 (1952).

[20] 12 U. S. C. § 93.

[21] Thus, in *Commissioner* v. *Lester*, 366 U. S. 299 (1961), in determining that a taxpayer should not be taxed on alimony payments to his divorced wife, the Court determined that it was more consistent with the basic precepts of income tax law that the wife, who received and had power to spend the payments, should be taxed rather than the husband who actually earned the money.

In *L. E. Shunk Latex Products, Inc.* v. *Commissioner*, 18 T. C. 940 (1952), the Tax Court considered a closely analogous situation. The same interest controlled a manufacturer and a distributor of rubber prophylactics. The OPA Price Regulations of World War II became effective on December 1, 1941. Prior thereto the distributor had raised its prices to retailers, but the manufacturer had not increased the prices charged to its affiliated distributor. The Commissioner, acting under § 482, attempted to allocate some of the distributor's income to the manufacturer on the ground that a portion of the distributor's profits were in fact earned by the manufacturer, even though the manufacturer was prohibited by the OPA regulations from increasing its prices. In holding that the Commissioner had acted improperly, the Tax Court said that he had "no authority to attribute to petitioners income which they could not have received." 18 T. C., at 961.[22]

It is argued, finally, that the "services" rendered by the Banks in making credit insurance available to customers "would have been compensated had the corpora-

[22] As noted at the outset of this opinion, certiorari was granted to resolve the conflict between the decision below and that in *Local Finance Corp.* v. *Commissioner*, 407 F. 2d 629 (CA7 1969). The Tax Court in this case felt bound to follow *Local Finance Corp.*, which was decided subsequently to *L. E. Shunk Latex Products, Inc.* v. *Commissioner*, 18 T. C. 940 (1952). For the reasons stated in the opinion above, we think *Local Finance Corp.* was erroneously decided and that the earlier views of the Tax Court were correct.

See *Teschner* v. *Commissioner*, 38 T. C. 1003, 1009 (1962):

"In the case before us, the taxpayer, while he had no power to *dispose* of income, had a power to appoint or designate its recipient. Does the existence or exercise of such a power alone give rise to taxable income in his hands? We think clearly not. In *Nicholas A. Stavroudis*, 27 T. C. 583, 590 (1956), we found it to be settled doctrine that a power to direct the distribution of trust income to others is not alone sufficient to justify the taxation of that income to the possessor of such a power."

tions been dealing with each other at arm's length." [23] The short answer is that the proscription against acting as insurance agent and receiving compensation therefor applies to *all* national banks located in places with population in excess of 5,000 inhabitants. It applies equally to such banks whether or not they are controlled by a holding company. If these Banks had been independent of any such control—as most banks are—no commissions or premiums could have been received lawfully and there would have been no taxable income.[24] As stated in the Treasury Regulations, the "purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer . . . ." [25] We think our holding comports with such parity treatment.

We conclude that the premium income received by Security Life could not be attributable to the Banks. Holding Company did not utilize its control over the Banks and Security Life to distort their true net incomes. The Commissioner's exercise of his § 482 authority was therefore unwarranted in this case. The judgment below is

Affirmed.

MR. JUSTICE MARSHALL, dissenting.

The facts of this case illustrate the natural affinity that lending institutions and insurance companies have for each other. Congress depends on the ability of the Commissioner of Internal Revenue to utilize § 482 of the Internal Revenue Code, 26 U. S. C. § 482, to insure that this affinity does not provide a basis for tax avoidance. H. R. Rep. No. 1098, 84th Cong., 1st Sess., 7; S. Rep. No. 1571, 84th Cong., 2d Sess., 8. In my opin-

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[23] See dissenting opinion of MR. JUSTICE BLACKMUN.

[24] If an unaffiliated bank were able to provide the insurance at a cheaper rate because no commissions were paid, this would benefit the customers but would result in no taxable income.

[25] 26 CFR § 1.482-1 (b)(1) (1971).

ion, today's decision renders § 482 a less efficacious weapon against tax avoidance schemes than Congress intended and provides the respondents with an unwarranted tax advantage. I dissent.

Section 482 provides:

> "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

First enacted as § 45 of the Revenue Act of 1928, 45 Stat. 806, the statute was intended to prevent the avoidance of tax liability through fictions and "to deny the power to shift income . . . arbitrarily among controlled corporations, and to place such corporations rather on a parity with uncontrolled concerns." *Central Cuba Sugar Co.* v. *Commissioner*, 198 F. 2d 214, 216 (CA2 1952). See H. R. Rep. No. 2, 70th Cong., 1st Sess., 16–17; S. Rep. No. 960, 70th Cong., 1st Sess., 24–25. It is intended to serve the same purpose in the present Code.

It is well-established law that in analyzing a transaction under § 482, the test is whether the arrangement as structured for income tax purposes by interlocking corporate interests would have been similarly structured by taxpayers dealing at arm's length. See, *e. g.*, *Borge* v. *Commissioner*, 405 F. 2d 673 (CA2 1968), cert. denied *sub nom. Danica Enterprises* v. *Commissioner*, 395 U. S.

933 (1969); *Eli Lilly & Co.* v. *United States,* 178 Ct. Cl. 666, 372 F. 2d 990 (1967).

Applying that test to this case, the following facts are relevant. Before 1954, an independent insurance company paid respondents commissions ranging from 40% to 45% for their services in offering insurance to borrowers designed to discharge their debts in the event that they died or became disabled during the term of their loans. After 1954, respondents offered borrowers policies issued by a different insurance company. At this time the holding company that controlled respondents created a new subsidiary to reinsure the borrowers who purchased policies. By paying off the independent insurance company with 15% of the proceeds of the policies, the subsidiary assumed the insurance risks and garnered the remaining 85% of the proceeds. No commission was paid to respondents by either the independent company or the insurance subsidiary.

The tax advantage of the post-1954 structure derived from the fact that the Life Insurance Company Tax Act for 1955, 70 Stat. 36, as amended by the Life Insurance Company Income Tax Act of 1959, 73 Stat. 112, as amended, 26 U. S. C. § 801 *et seq.*, gives preferential tax treatment to life insurance companies. By funneling all proceeds from the sales of the insurance policies to a subsidiary that qualified for tax treatment as a life insurance company, the holding company avoided the heavier tax that would have been imposed on respondents had they been paid commissions.

The Commissioner's analysis of this case is not overly complex: He saw that respondents performed essentially the same services and generated the same income after 1954 that they did before, and he concluded that § 482 required that they should be taxed on the premiums that they were actually earning.

Based on respondents' earlier experience dealing *at arm's length* with an independent insurance company and on the well-known fact that insurers pay solicitors a portion of the premium as a commission for generating income, see *Local Finance Corp.* v. *Commissioner*, 48 T. C. 773, 786 (1967), aff'd, 407 F. 2d 629, 631–632 (CA7 1969), the Commissioner determined that 40% of the premium income was properly allocated to respondents.

The respondents make, in essence, two arguments in their attempt to rebut the Commissioner's position. First, they urge that they never received any funds as a result of offering the policies to borrowers, and that it is therefore unfair to tax them on any portion of said proceeds. If § 482 is to have any meaning, that argument must be rejected. It makes absolutely no sense to examine this case with a technical eye as to whether respondents actually received or had a "right" to receive any commissions. This is not a case involving independent companies or private individuals where we must scrupulously avoid taxing someone on money he will never receive regardless of his will in the matter. See, *e. g.*, *Blair* v. *Commissioner*, 300 U. S. 5 (1937); cf. *Teschner* v. *Commissioner*, 38 T. C. 1003 (1962). This is a case involving related corporations, and § 482 recognizes that such corporations may be treated differently from natural persons or unrelated corporations for certain tax purposes.

We need not look far to find that this entire complicated economic structure—established, designed, administered, and amendable by the holding company—had the right to the proceeds. Pursuant to § 482, the Commissioner properly attempted to insure that the proceeds would be equitably allocated.

The Court apparently concedes that if respondents' only argument against taxation were that they have

received no money, that argument would fail. This concession is, in fact, mandated by various decisions of this Court, including *Harrison* v. *Schaffner*, 312 U. S. 579 (1941); *Helvering* v. *Horst*, 311 U. S. 112 (1940), and *Lucas* v. *Earl*, 281 U. S. 111 (1930).

Having implicitly rejected the argument that mere nonreceipt of money is sufficient to avoid taxation, the Court proceeds to accept respondents' second argument that in this case the taxpayer is legally barred from ever receiving money, and in this circumstance he cannot be taxed on it. Respondents find a legal bar to receipt of the proceeds at issue here in 12 U. S. C. A. § 92, which provides:

> "In addition to the powers now vested by law in national banking associations organized under the laws of the United States any such association located and doing business in any place the population of which does not exceed five thousand inhabitants, as shown by the last preceding decennial census, may, under such rules and regulations as may be prescribed by the Comptroller of the Currency, act as the agent for any fire, life, or other insurance company authorized by the authorities of the State in which such bank is located to do business in said State, by soliciting and selling insurance and collecting premiums on policies issued by such company; and may receive for services so rendered such fees or commissions as may be agreed upon between the said association and the insurance company for which it may act as agent; and may also act as the broker or agent for others in making or procuring loans on real estate located within one hundred miles of the place in which said bank may be located, receiving for such services a reasonable fee or commission: *Provided, however,* That no such bank shall in any case guarantee

> either the principal or interest of any such loans or assume or guarantee the payment of any premium on insurance policies issued through its agency by its principal: *And provided further*, That the bank shall not guarantee the truth of any statement made by an assured in filing his application for insurance."

This statute by inference and the regulations of the Comptroller of the Currency, 12 CFR §§ 2.1–2.5, by explicit language bar national banks in communities with more than 5,000 inhabitants from selling, soliciting, or receiving the proceeds from selling insurance. Respondents are within the legal prohibition and the penalties provided for a violation are indeed severe. Assuming that the respondents will not attempt to violate the law and not wishing to appear to encourage a violation, the Court concludes that respondents will receive none of the proceeds and that they cannot be taxed on money they will never receive.

But the crucial fact in this case is that under their own theory respondents have already violated the federal statute and regulations by soliciting insurance premiums. 12 U. S. C. A. § 92 was added to the federal banking laws in 1916 at the suggestion of John Skelton Williams, who was then Comptroller of the Currency. He wrote to Congress to recommend that national banks in small communities be permitted to associate with insurance companies, but that banks in larger communities be prohibited from doing the same:

> "It seems desirable from the standpoint of public policy and banking efficiency that this authority should be limited to banks in small communities. This additional income will strengthen them and increase their ability to make a fair return to their shareholders, while the new business is not likely to

> assume such proportions as to distract the officers of the bank from the principal business of banking. Furthermore in many small places the amount of insurance policies written . . . is not sufficient to take up the entire time of an insurance broker, and the bank is not therefore likely to trespass upon outside business naturally belonging to others.
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> "I think it would be unwise and therefore undesirable to confer this privilege generally upon banks in large cities where the legitimate business of banking affords ample scope for the energies of trained and expert bankers. I think it would be unfortunate if any movement should be made in the direction of placing the banks of the country in the category of department stores. . . ." Letter of June 8, 1916, to Senate, 53 Cong. Rec. 11001.

There is nothing in the history of the provision to indicate that Congress was more concerned with banks' actually receiving money than with their performing the activities that generated the money. In fact, the history that is available indicates that it is the activities themselves that Congress wished to stop. Banks in large communities were simply not permitted to do anything that insurance agents might do, *i. e.,* they were not permitted to solicit insurance.

Under respondents' theory of the case, the legal violation is thus a *fait accompli* and the respondents are taxable as if there had been no illegality.[1] See, *e. g., United*

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[1] Neither the statute nor the regulations use the words "originating and referring" insurance. These are the words chosen by the Court to describe the respondents' activities, *ante,* at 405. The statute and regulations speak of "soliciting and selling." Because the respondents themselves argue that they would violate § 92 and the regulations were they to receive the income generated by their activities, I assume that they, in effect, are admitting that these activities amounted to "soliciting and selling" insurance. Thus,

States v. *Sullivan*, 274 U. S. 259 (1927); *Rutkin* v. *United States*, 343 U. S. 130 (1952); *James* v. *United States*, 366 U. S. 213 (1961). See also *Tank Truck Rentals* v. *Commissioner*, 356 U. S. 30 (1958).

the Commissioner could properly determine that the statute was violated by the acts of solicitation, and, as the Court recognizes, since "the illegality involved was the act which gave rise to the income," this Court's prior decisions permit the Commissioner to tax the income of the lawbreakers.

If, however, the Court is attempting to distinguish *sub silentio* between "originating and referring" and "soliciting" and is concluding that only the latter is illegal, then there is nothing in the statute or regulations that would make illegal the receipt of income generated by the former. Hence, the Commissioner could reject the respondents' second argument that it would violate federal banking laws to include the proceeds in their income.

Whichever approach the Court selects, the statute requires consistency—*i. e.*, the statute requires that the activities that produce income be illegal before the receipt of the income is deemed to violate the law.

I agree with the Court that deference must be paid to the expertise of the Comptroller, but in proposing that § 92 be added to the already existing banking laws, Comptroller Williams himself noted that "[i]t is certainly clear that the Comptroller of the Currency has no right to authorize or permit a national bank to exercise powers not conferred upon it by law." Letter of June 8, 1916, *supra*.

Senator Owen, who shepherded the 1916 legislation through the Senate, noted at one point that § 92 is not a very important part of the statute. 53 Cong. Rec. 11001. Perhaps it is therefore unimportant whether or not the respondents have technically violated it. Whether or not the Comptroller has properly permitted such activities to take place may also be of no great moment.

What is critical to a correct disposition of this case, in my view, is that if respondents' activities are not illegal, there is no reason that receipt of the income generated from them should be illegal. It should be pointed out that the theory that receipt of said income would be illegal was first proffered by respondents' counsel. This theory is certainly self-serving in the sense that it provides what the Court regards as the dispositive factor in this case without hindering the activities of the holding company in any way.

The Court suggests that the Commissioner has never relied on the

The Court seeks, however, to distinguish all of the prior cases holding that a taxpayer may be taxed on income illegally earned on the ground that the issue was never raised as to whether the taxpayers in those cases had actually received the income. The distinction is valid but it does not warrant a different result in this case.

The reasoning of the majority runs along these lines: if A violates the law—by attempted embezzlement or by illegally soliciting insurance sales, for example—but he receives no money and has no "legal right" to receive any money, then he cannot be taxed as if the money had been received; but, if A actually embezzles money or receives insurance premiums in violation of the law, A can be taxed even though he may have transferred the money without any personal gain to a third party from whom he has no right of recovery.

I would agree with this analysis in most cases. Where I differ from the Court is in which category to place this transaction. To pretend that respondents have not received any money and have no right to any money is to ignore the thrust of § 482. That section requires that we treat this case as if the commissions had been paid to

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theory of the case expressed in this opinion. On the contrary, the Commissioner argued in his brief (p. 13) as follows:

"The Commissioner's allocation does not force respondents to violate the federal banking law. It was they, not the Commissioner, who chose to solicit and sell credit life insurance at a rate set at a sufficiently high level to permit the payment of commissions. If their activities did not violate the banking law, the Commissioner's allocation will not, of itself, constitute a violation on their part. And, surely, the payment of taxes would not be an illegal act."

Both sides dealt with this point in oral argument. Tr. of Oral Arg. 14–18, 30, 40.

This is the nub of the case. What is there in the legislative history or the purpose of § 92 that requires that we treat the activities as legal, but the receipt of the income they generate as illegal?

respondents and had been transferred to the insurance subsidiary by them. Of course, that did not occur. But, we know that the whole notion of the section is to look behind the form in which a transaction is structured to its substance. The substance is either that the respondents violated federal law, earned illegal income, attempted to avoid taxation on the income by channeling it elsewhere and were caught by the Commissioner; or, that they did not violate federal law by soliciting sales of insurance and that there is no legal bar to their receiving the proceeds from their sales. In either case, the result is the same, and respondents cannot prevail.

If respondents had actually received the proceeds and transferred them to the insurance subsidiary, they would still be free to make essentially the same argument that they make in this case, *i. e.*, they could argue that federal law prohibited them from receiving the money; that they violated federal law, but had no right to keep the money; and that they should not be taxed on receipt of funds which they could not legally keep.

To be consistent with the assignment-of-income cases, *Helvering* v. *Horst, supra,* and *Lucas* v. *Earl, supra,* and the line of cases that includes *Rutkin* v. *United States, supra,* and *James* v. *United States, supra,* the Court would have to reject this argument. Yet, I maintain that this is just what the taxpayer is arguing here. The Commissioner has determined that in reality the respondents have earned income, and he has taxed it under § 482. To reject his position is to give undue weight to the absence of technical temporary possession of money and some abstract concept of a "right" to receive it. I had thought that this kind of technical reasoning was rejected in *James* v. *United States, supra,* when the Court overruled *Commissioner* v. *Wilcox,* 327 U. S. 404 (1946).

Finally, even if there is some mysterious reason why the banking laws should be read in the manner suggested by respondents, there is still another reason why they should not prevail. The fact would remain that they consciously chose to perform services in order that their parent holding company would reap financial rewards.[2] Certainly, there is nothing in the federal banking laws that required the performance of these services. In the context of a complex corporate structure ministered by one large holding company, the purposes of § 482 are best served by permitting the Commissioner to allocate income to the company that earns it, rather than to the company that receives it. Again, we must remember that this is not a case of unrelated private individuals or independent corporations where there might be some danger that in allocating income to the person who generated but did not receive it, the Commissioner would render that person financially unable to pay his taxes. This case involves one large interrelated system. It would be total fiction to assume that the holding company would leave its subsidiaries in a financial bind. Hence, there is no good reason to bar the Commissioner from taxing respondents on the money that they earn.[3]

In my view, the Commissioner has done exactly what § 482 requires him to do in this case. Accordingly, I

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[2] While the premiums from the insurance policies were not paid directly to the parent, there can be no doubt that the parent benefited from the financial success of its subsidiaries.

[3] We know that nontax statutes do not normally determine the tax consequences of a particular transaction. There is no inherent inconsistency in reading the banking legislation as making the receipt of insurance premiums illegal, and, at the same time, reading the Internal Revenue Code as allowing the Commissioner to allocate the income from the sale of insurance policies to the party actually earning it, so long as the income is received by the corporation controlling that party.

would reverse the decision of the Court of Appeals and would remand the case with a direction that judgment be entered for the petitioner.

MR. JUSTICE BLACKMUN, with whom MR. JUSTICE WHITE joins, dissenting.

As I read the Court's opinion, I gain the impression that it chooses to link legality with taxability or, to put it better oppositely, that it ties illegality to receive with inability to tax. I find in the Internal Revenue Code no authority for the concoction of a restrictive connection of that kind. Because I think that the Commissioner's allocation of income here, under the auspices of § 482 of the 1954 Code, and in the light of the established facts, was proper, I dissent.

1. Section 482[1] surely contemplates taxation of income without formal receipt of that income. That, indeed, is the scope and purport of the statute. It is directed at income distortion by a controlling interest among two or more of the controlled entities. I, therefore, am not convinced that the fact the income in question here did not flow through the Banks at any time—because it was deemed proscribed by the 1916 Act (if the pertinent portion thereof, 39 Stat. 753, is still in effect, a proposition which may not be free from doubt),[2] and because the

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[1] Section 482 is not new. It appeared as § 45 of the Revenue Act of 1928, 45 Stat. 806, and has predecessors in § 240 (f) of the Revenue Act of 1926, 44 Stat. 46, and in § 240 (d) of the Revenue Act of 1924, 43 Stat. 288.

[2] The revisers of the United States Code in 1952 omitted the section because of the possibility of its having been repealed by its omission from the amendment and re-enactment in 1918 of § 5202 of the Revised Statutes by § 20 of the War Finance Corporation Act, 40 Stat. 512. Compare administrative ruling No. 7110 of the Comptroller of the Currency with the Comptroller's current regulations, 12 CFR §§ 2.1–2.5. See *Saxon* v. *Georgia Association of Independent Insurance Agents, Inc.*, 399 F. 2d 1010 (CA5 1968); *Com-*

controlling interest routed it elsewhere—serves, in and of itself, to deny the efficacy of the statute.

2. Section 482 has a double purpose and a double target. It authorizes the Secretary or his delegate, that is, the Commissioner, to allocate whenever he determines it necessary so to do in order (a) "to prevent evasion of taxes" or (b) "clearly to reflect the income of any" of the controlled entities. The use of the statute, therefore, is not restricted to the intentional tax evasion. No evasion of tax, in the criminal sense, by these Banks is specifically suggested or at issue here. And I do not subscribe to my Brother MARSHALL's intimation that what the Banks were doing was otherwise illegal. The second alternative of the statute, however, is directed at something other than tax evasion or illegality. It is concerned with the proper reflection of income (or deductions, credits, or allowances) so as to place the controlled taxpayer on a tax parity with the uncontrolled taxpayer. It is designed to produce for tax purposes, and to recognize, economic realities and to have the tax consequences follow those realities and not some structured nonreality. This is the aspect of the statute with which the Commissioner and these respondents are here concerned. Thus, legality and illegality seem to me to be beside the point.

3. From this it follows that the Court's repetitive emphasis on the missing § 92 and the inability of these Banks legally to receive the insurance commissions give undue emphasis to the first alternative of § 482, and seem almost wholly to ignore the second.

4. The purpose of the controlling interest in structuring the several entities it controls is apparent and can-

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missioner v. *Morris Trust,* 367 F. 2d 794, 795 (CA4 1966); Hackley, Our Baffling Banking System, pt. 2, 52 Va. L. Rev. 771, 777–779 (1966). United States Code Annotated carries the provision as § 92 of its Title 12.

not be concealed. The Banks were wholly owned subsidiaries of Holding Company. The Tax Court found—and the respondents concede [3]—that one of the purposes of the Banks' arranging for borrowers' credit life insurance [4] was "to provide an additional source of income—part of the premiums from the insurance—to Holding Company or its subsidiaries." T. C. Memo 1967–256, p. 67–1453. For me, that means to provide an additional source of income for the group irrespective of the particular pocket into which that income might initially be routed.

5. What, then, happened? The chronology is revealing:

(a) Initially, that is, until 1954, the Banks solicited the insurance, charged the premium, and forwarded it to Management Company. The latter in turn sent it on to the then-favored independent insurance carrier. That carrier paid the recognized sales commission to Smith, Management Company's wholly owned insurance agency.[5]

(b) In 1954 the American National-Security Life arrangement appeared on the scene. This was prompted by the blossoming of the credit insurance business as a profitable undertaking. Obviously, it was a matter of concern to established and independent insurance companies when they came to realize that lending institutions were in a position to form their own insurance affiliates

[3] Respondents' Brief 2.

[4] I use this and other terms as they have been defined in the Court's opinion.

[5] Despite this payment to Smith, it was not Smith, but Management Company, that reported the commissions as taxable income. This reveals the fluidity of control of the structure. Of course the fact that the Commissioner did not allocate the premiums to the Banks during this period is of small, if any, significance, for, as the Court points out in its footnote 2, *ante*, at 397–398, the then tax rate for each of the corporate entities was likely the same. The Government thus would lose nothing by not allocating.

to tap and drain away profits that the independents theretofore had received without hindrance. Security Life was just such an emerging insurance affiliate of Holding Company and of Management Company. But American National, by its proposal to Management Company, as well as to other financial institutions, salvaged 15% of the premium dollar in return for actuarial and accounting services. Security Life never did develop into a full-line insurance company; it remained essentially a re-insurer and yet it accomplished the purpose for which it was given life. Now no sales commissions needed to be paid. In fact, none were paid; they just disappeared, and that erstwhile cost remained as profit in Security Life. But the Banks, as before, solicited their borrowing customers to purchase credit life insurance.

(c) The Life Insurance Company Tax Act for 1955 was enacted, 70 Stat. 36, followed by the Life Insurance Company Income Tax Act of 1959, 73 Stat. 112. These statutes served to accord preferential tax treatment—as compared to ordinary corporations—to life insurance companies. See *United States* v. *Atlas Life Ins. Co.*, 381 U. S. 233 (1965). This happily coincided, of course, with Security Life's development.

6. Only the Banks were the responsible force behind the premium income. No one else was. Certainly American National was not. Certainly Security Life was not. Smith was out of the picture. And if it can be said that Management Company or Holding Company contributed a part, they did so only secondarily. It was the participating bank that explained to the borrower the function and availability of the insurance; that gave the customer the application form; that examined the application; that prepared the certificate of insurance; that collected the premium or added it to the loan; and that sent the form and the premium to Management Company. It was the participating bank that thus

offered and sold on behalf of a life insurance company under common control with the bank. It was the participating bank, in short, that did what was necessary, and all that was necessary, to sell the insurance. Clearly, services were rendered by that bank on behalf of its commonly controlled affiliate. Just as clearly, those services would have been compensated had the corporations been dealing with each other at arm's length.

7. It is no answer to say that generation of income does not necessarily lead to taxation of the generator; here the earnings themselves stayed within the corporate structure dominated by Holding Company, and did not pass elsewhere with consequent tax impact elsewhere. I do not so easily differentiate, as does the Court in its footnote 11, *ante*, at 401, between referral outside the affiliated structure and referral conveniently within that structure to a re-insurance company that could be taxed on the premium income (unreduced by commissions) at advantageous tax rates.

8. That the selling effort of the Banks seems comparatively minimal and that the processing cost seems comparatively negligible are, I believe, beside the point and quite irrelevant. No one else devoted effort or incurred cost of any significance whatsoever. Taxability has never depended on approximating expenses to receipts; in fact, the less the cost, the greater the net income and the greater the tax burden.

9. Neither is it an answer to say that before the organization of Security Life the Banks did not receive income from credit insurance premiums and that, therefore, the emergence of Security Life did not change the situation so far as the Banks were concerned. For me, it very much changed the situation, for the controlled structure took over the insurance business and the premiums thenceforth were nestled within that structure.

10. Taxability, despite nonreceipt, is common in our tax law. It is present in a variety of contexts. For example, one has been held taxable, under the applicable statute's general definition of gross income, for income or earnings assigned to another and never received;[6] for the income from bond coupons, maturing in the future, assigned to another and never received;[7] for dividends paid to the shareholders of a transferor corporation pursuant to a lease with no defeasance clause;[8] for another's income from a short-term trust[9] (until § 673, with its 10-year measure, came into the tax structure with the 1954 Code); for the employer's payment of income taxes on his employees' compensations;[10] and for an irrevocable trust's income used to pay insurance premiums on the settlor's life,[11] or, in the absence of particular state law provisions, distributed to a divorced wife in lieu of alimony[12] (until § 215 came into the Code with the Revenue Act of 1942, 56 Stat. 817).

11. In the area of federal estate taxation an obvious parallel is found in the many instances of includability in the decedent's gross estate of property not owned or possessed by the decedent at his death. The Code itself provides for the inclusion of transfers theretofore effec-

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[6] *Harrison* v. *Schaffner*, 312 U. S. 579 (1941); *Helvering* v. *Eubank*, 311 U. S. 122 (1940); *Burnet* v. *Leininger*, 285 U. S. 136 (1932); *Lucas* v. *Earl*, 281 U. S. 111 (1930). Cf. *Hoeper* v. *Tax Comm'n*, 284 U. S. 206 (1931); *Blair* v. *Commissioner*, 300 U. S. 5 (1937). See *Commissioner* v. *Sunnen*, 333 U. S. 591, 604-610 (1948); *United States* v. *Mitchell*, 403 U. S. 190 (1971).

[7] *Helvering* v. *Horst*, 311 U. S. 112 (1940).

[8] *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44 (1942).

[9] *Helvering* v. *Clifford*, 309 U. S. 331 (1940).

[10] *Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716 (1929).

[11] *Burnet* v. *Wells*, 289 U. S. 670 (1933).

[12] *Douglas* v. *Willcuts*, 296 U. S. 1 (1935); *Helvering* v. *Fitch*, 309 U. S. 149 (1940); see *Commissioner* v. *Lester*, 366 U. S. 299 (1961).

tively made, but in contemplation of death, 26 U. S. C. § 2035; of a variety of *inter vivos* irrevocable transfers in trust, 26 U. S. C. §§ 2036–2038; and of joint interests, 26 U. S. C. § 2040, in all of which situations the ownership interest at death was nonexistent or less than full.

12. This demonstrates for me that there have been and are many examples of taxation of income without that "complete dominion" over it that the Court now finds so necessary. The quotation, cited by the Court, from Mr. Justice Holmes' opinion in *Corliss* v. *Bowers*, 281 U. S. 376, 378 (1930), consists of language used to *support* the taxation of income; it is not language, as the Court would make it out to be, that supported the nontaxation of income. The Justice's posture—and the Court's—in that case surely looks as much, and perhaps more, to includability here than it does to excludability.[13]

13. The Court shrinks from extending the possibility of taxation-without-receipt to the situation where the taxpayer is "prohibited from receiving" the income by another statute. It states that no decision of the Court has as yet gone that far. It is equally true that no decision of the Court has refrained from going that far.

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[13] ". . . But the net income for 1924 was paid over to the petitioner's wife and the petitioner's argument is that however it might have been in different circumstances the income never was his and he cannot be taxed for it. The legal estate was in the trustee and the equitable interest in the wife.

"But taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid. . . ." 281 U. S., at 377–378.

In another case Mr. Justice Holmes said:

"There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. . . ." *Lucas* v. *Earl*, 281 U. S. 111, 114–115 (1930).

The Seventh Circuit has not been concerned with the existence of a prohibitory regulating statute, *Local Finance Corp.* v. *Commissioner*, 407 F. 2d 629 (1969), cert. denied, 396 U. S. 956, and this Court should not be. The Congress, in enacting the Life Insurance Company Tax Act for 1955, was of the opinion that § 482 was available to the Commissioner with respect to insurance companies that are captives of "finance companies." H. R. Rep. No. 1098, 84th Cong., 1st Sess., 7; S. Rep. No. 1571, 84th Cong., 2d Sess., 8.[14]

14. The Court's reluctance is reminiscent of the "claim of right" doctrine which found expression in the unfortunate and short-lived (15 years) decision in *Commissioner* v. *Wilcox*, 327 U. S. 404 (1946), to the effect that embezzled income was not taxable to the embezzler. *Wilcox*, of course, stood in sharp contrast to *Rutkin* v. *United States*, 343 U. S. 130 (1952), where money obtained by extortion was held to be taxable income to the extortioner; it was overruled, at last, in *James* v. *United States*, 366 U. S. 213 (1961). In *Wilcox*, as here, the Court wrestled with the concept and imaginary barrier of illegality, was impressed by it, and, as in this case, concluded that illegality and taxability did not mix and could not be linked. That doctrine encountered resistance in *Rutkin* and in *James*, and was rightly rendered an aberration by those later decisions.

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[14] "There is a potential abuse situation in the case of the so-called captive insurance companies. It may be possible for a finance company, for example, to establish a subsidiary life insurance company that will issue life insurance policies in connection with the business of the parent. If the subsidiary charges excessive premium on this business, a portion of the income of the parent company can be diverted to the life insurance company. It is believed that section 482 of the Internal Revenue Code of 1954 (relating to allocation of income and deductions among related taxpayers) provides the Secretary of the Treasury ample regulative authority to deal with this problem."

15. I doubt if there is much comfort for the Court in *L. E. Shunk Latex Products, Inc.*, 18 T. C. 940 (1952), for there the significant fact was that the taxpayer could not have raised its price even to a noncontrolled distributor.

In conclusion, I note that the Court of Appeals remanded Management Company's case to the Tax Court for consideration of the § 482 allocation, alternatively proposed, to that corporation. With this I must be content. At least Management Company is not a national bank, and the barrier that the Court has found in the missing § 92 supposedly does not provide a protective coating for Management Company or, for that matter, for Holding Company.

And so it is. The result of today's decision may not be too important, for it affects only a few taxpayers. It seems to me, however, that it effectively dulls one edge of what has been a sharp two-edged tool fashioned and bestowed by the Congress upon the Internal Revenue Service for the effective enforcement of our federal tax laws.